



**Alternative Investment Fund Managers Directive**  
**The 'Depository-Lite' Regime – A Practical Perspective**

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# Contents

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- AIFMD Depositary Requirements
- Depositary-Lite Requirements
- Current Regulatory Position
- Evolving Depositary-Lite Models
- The Hedge Fund Depositary-Lite Landscape
- Marketing vs. Reverse Solicitation
- Obtaining Value from Depositary-Lite
- On-boarding Considerations
- About INDOS Financial
- Contacts

# AIFMD Depositary Requirements

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AIFMD Depositary requirements are driven by a combination of the domicile of the AIFM and AIF and marketing practices:

- EU AIFM of EU AIF – Subject to Full Depositary requirements (Article 21).
- EU AIFM of non-EU AIF – Subject to lighter depositary regime (Article 36) – **only if** the non EU-AIF marketed to EU investors through private placement.
- Non-EU AIFM of EU or non-EU AIF – not subject (at least initially) to any depositary requirements irrespective of whether AIF being marketed to EU investors, except if marketing into certain countries (e.g. Germany, Denmark , France and Austria), and any other country specific requirements (e.g. Ireland QIAIF requirements).

# Depository-Lite Requirements

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- Non-EU AIFs marketed by an EU AIFM (and certain non-EU AIFM) to EU investors through private placement are subject to certain depository requirements (*Article 36 AIFMD*).
- An AIFM must ensure **one or more entities** are appointed to carry out the depository duties of:
  - Cash flow monitoring (*Article 21.7*);
  - Safe keeping of financial instruments and verification of other assets (*Articles 21.8a & b*);
  - Oversight (valuation, subs & reds, compliance with laws and regulations including investment restrictions and leverage, timely settlement of transactions & distributions) (*Article 21.9*)
- Unlike Article 21 (which applies to EU AIFM / EU AIF) there is no strict liability for loss of assets for a non-EU AIF, and no requirement to appoint a single depository - therefore this regime is referred to as 'Depository-Lite'.

# Current Regulatory Position

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- Article 36 does not prescribe any regulatory or domicile requirements for firms undertaking the depositary-lite duties. Member state regulators therefore determine whether to apply such requirements.
- As examples:
  - Where a UK firm provides any of the services it must hold an Article 36 Custodian/ Part 4a FSMA 2000 FCA authorisation. The Maltese FSA take a similar approach.
  - The Central Bank of Ireland has stated Irish firms undertaking the oversight and cash flow monitoring duties do not require regulatory authorisation. It is currently unclear whether the same applies for record keeping of other assets since an Irish custody regulatory authorisation may be required.
- If the AIFMD passport is extended to non-EU funds, 'member state of reference' rules currently require the depositary to be domiciled in the domicile of the AIFM or AIF. In the UK, the FCA rule book (FUND 12) pre-empts this & requires a UK AIFM to appoint either a UK depositary or one in the domicile of the AIF.

# Evolving Depositary-Lite models

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Different depositary-lite models are evolving as the table below highlights:

| <b>Depositary Duties from AIFMD Articles</b>            | <b>Model 1<br/>Single Depositary</b> | <b>Model 2<br/>Hybrid</b> | <b>Model 3<br/>Multi Firm</b> |
|---|--------------------------------------|---------------------------|-------------------------------|
| Article 21(7) – Cash flow Monitoring                    | Single Depositary                    | Depo Firm                 | Administrator                 |
| Article 21(8)(a) – Safekeeping of financial instruments |                                      | Prime Broker/s            | Prime Broker/s                |
| Article 21(8)(b) – Record keeping of other assets       |                                      | Depo Firm                 | Administrator                 |
| Article 21(9) - Oversight                               |                                      | Depo Firm                 | Depo Firm                     |

# The Hedge Fund Depository-Lite Landscape

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- Majority of depository businesses today are divisions of large banking/ custody groups. As a general rule these firms will only act where an affiliate performs the fund administration unless there is a clear strategic reason.
- There are few depositaries willing to act for hedge funds in an independent capacity, where an affiliate does not perform fund accounting.
- There are a number of independent hedge fund administrators whose businesses are primarily focussed on offshore/ non EU hedge funds. These firms have not traditionally had a depository capability and either need to (a) establish own depository capability or (b) work with depositaries that might be willing to act.
- Some independent administrators have decided not to establish a depo-lite capability, whereas others are in the process of doing so, either in Ireland or via the UK Article 36 Custodian route.
- We expect a number of firms will not be ready by 22 July 2014 to on-board funds.

# Marketing vs. Reverse Solicitation

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- As noted, managers of non-EU funds can avoid the AIFMD depositary requirements altogether if they do not 'market' to EU investors through private placement or rely on reverse solicitation.
- The definition of marketing under the directive is very broad and AIFMD is expected to raise marketing up the regulatory 'radar'. Very few regulators have to date issued guidance as to how they interpret and will apply the marketing rules.
- Some managers recognise the risk of non-compliance is broader than just a regulatory risk. It extends to the ability for investors to bring private actions against the manager in future for breach of the marketing rules.
- Compliance with depositary-lite helps managers mitigate the risk of non-compliance and ensures they have the building blocks in place to market through private placement.
- Anecdotally, we expect approximately 2/3<sup>rd</sup> of non EU funds managed by EU managers will seek to comply with depo-lite – but not all by 22 July 2014.



# Obtaining Value from Depositary-Lite

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- Depending on the providers and model, costs (paid for by the AIF) are likely to range between 2 and 4bps - How can managers and investors get value in return?
- For most hedge funds, the safe keeping and cash flow monitoring duties are largely performed today by prime brokers and administrators and managers see little if any additional value.
- On the other hand, two key areas of risk to investors are NAV accuracy and investment mandate compliance. Oversight of these areas is a key element of the depositary-lite oversight duties.
- When implemented well, the oversight duties should add real value to investors and managers.
- Managers and investors should be looking for a transparent and objective service.

# On-Boarding Considerations

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- Many managers face a challenge to become AIFMD ready by mid-2014. This, together with the potential volume of firms requiring depo-lite services, means a pragmatic approach to on-boarding is required from the industry.
- For UK managers, FCA guidance states managers should notify the FCA of their chosen depositary provider(s) by 21 June assuming they are targeting 22 July as their date of authorisation.
- A typical on-boarding process will involve:
  - Manager and depositary undertaking due diligence over each other;
  - Negotiation of contracts and commercial terms;
  - Establishing SLAs and operating models between parties;
  - Disclosure in offering documents.
- Managers should be making decisions now to avoid depositary-lite becoming increasingly more difficult to implement before 22 July.

# About INDOS Financial

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- UK entity established in late 2012 to enable EU, and certain non-EU, AIFM managing non-EEA hedge funds to meet depositary-lite requirements.
- INDOS provides AIFMD compliant, independent depositary-lite services, using experienced hedge fund professionals with a mix of trustee, fund accounting & oversight experience from offices in UK and Ireland.
- INDOS was the first Article 36 Custodian to be authorised by the FCA in the UK in January 2014.
- Currently in the process of on-boarding funds (both new launches unable to use transitional year, and established managers seeking to comply with the AIFMD by 22 July 2014) across a range of fund administrators.

# Contacts

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## Disclaimer:

The information contained in this presentation does not constitute legal advice. Firms seeking to market alternative investment funds in the EU under the AIFMD should seek professional legal advice with respect to the depositary and other regulations which apply in each country in which the manage or market funds. We accept no responsibility for the accuracy of the information contained herein.