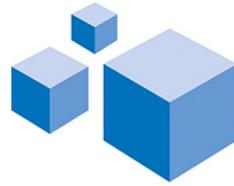


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AIFMD 'Depository-Lite'

Overview of Requirements and Considerations for Hedge Fund Managers

20 September 2013

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AIFMD Depositary Requirements

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) – mandatory in order to market 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 potentially if marketing into certain countries (e.g. Germany, Denmark, France ‘gold plating’), and any other country specific requirements (e.g. Ireland QIAIF requirements)

Depositary-lite requirements & final UK regulatory position

- Non-EU AIFs marketed by an EU AIFM to EU investors through private placement are subject to certain depositary requirements (*Article 36 AIFMD*)
- An AIFM must ensure one or more entities are appointed to carry out the following duties of:
 - Cash flow monitoring (*Article 21.7*);
 - Safe keeping of assets, both financial instruments and OTC (*Articles 21.8a and 21.8b*); and
 - Oversight (covered later) (*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 depositary - therefore this regime is referred to as 'Depositary-Lite'

Depository-lite requirements & final UK regulatory position.... continued

- Existing prime broker(s) and custodian(s) and existing administrator, already substantially perform AIFMD requirements of safe keeping and cash monitoring, respectively. The Oversight duties are an entirely new requirement for non-EU funds
- Until recently the FCA took the view that for any non-EU AIF managed by an EU AIFM and marketed in the UK, & where any of duties performed by UK firm, a single UK firm was required to perform all three. The FCA reconsidered this approach and multiple providers are now allowed
- Where a UK firm provides any of the services it must hold an Article 36 Custodian/ Part 4a FSMA 2000 FCA authorisation. Non-UK firms can be appointed, but we expect the FCA will want to be comfortable appropriate firms are proposed in the AIFM's Variation of Permission Application
- Whilst currently no requirements for the depository to be domiciled in UK, if the AIFMD passport is extended to non-EU AIF managed by UK AIFM, FCA rule book (FUND 12) states depository must be domiciled in UK or in the domicile of the AIF.

Expected Depository-lite models

- Different depository-lite models are emerging:

Model 1: Multiple-provider approach of Article 36

Safe keeping of financial instruments: Existing Prime Brokers / Cash Custodians

Cash flow monitoring: Administrator

Non custody assets: Administrator

Oversight: Depository

Model 2: Single depository performs all duties

- Model 1 is gaining momentum as the preferred model. It is expected to minimise disruption to current business processes, be lower cost and preferred by many managers, prime brokers and administrators. Managers will retain the most flexibility with respect to selection and use of prime brokers since there is no sub-custodian relationship between a single depository and PB.

The Depository Landscape

- 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 (i.e. larger funds, important business relationship etc.)
- There are no independent AIFMD depository businesses which specialise in the hedge fund market. By comparison, there are at least 5 new firms either authorised or seeking to become authorised AIFMD depositories in the Private Equity/ Real Estate AIF market
- There are a large number of independent hedge fund administrators whose businesses are primarily focussed on offshore/ non-EU hedge funds. These firms do not have a depository capability and either need to (a) establish own depository capability or (b) work with depositories that might be willing to act or a combination of both
- Some independent administrators have decided not to do (a) whilst a small number have decided they will. The challenge all administrators face is an unclear regulatory framework outside of the UK, notably in Ireland and Cayman Islands & time is running out especially given FCA accelerated VoP timetable
- Against this backdrop, investors and managers are increasingly conscious of the inherent conflicts of interest of the affiliated depository/ administration model. With the industry focus on best practice and conflicts of interests, there are clear advantages to an independent model.

The Oversight Duties

- The Article 21(9) oversight duties, supplemented by AIFMD Level 2 Articles 92-97, are broadly as follows:
 - The valuation of the AIF and its shares is carried out in accordance with its valuation policy, applicable laws and fund rules
 - Subscriptions and redemptions are carried out in accordance with applicable laws and AIF rules
 - Transactions are settled within the usual time limits
 - The AIFM and AIF comply with applicable laws and regulations
 - The AIF complies with investment restrictions and manager-defined leverage limits
 - An AIF's income is applied in accordance with applicable law and the AIF rules or instruments of incorporation.

Considerations for Managers

- Whether to comply with depo-lite. Even if AIFMs plan to rely on reverse solicitation, depo-lite can mitigate risk of non-compliance, provides flexibility for marketing should opportunities arise
- What options do you have (e.g. depo affiliate of administrator, independent such as INDOS or others?)
- Can depo-lite add value to your business (e.g. guideline monitoring) and help mitigate risk (e.g. AIFMs responsible for valuation errors post AIFMD. Depo-lite oversight will help mitigate this risk)
- Investor expectations/ perception (independence, regulation, reputation and financial strength/ insurance). Feedback from investors and board directors is that they value an independent model and are keeping an open mind with respect to 'balance sheet' vs. 'insurance' backed solutions
- On-boarding considerations (e.g. balanced contractual terms, flexibility, depo-lite due diligence over AIFM and vice versa)
- Very short timeframes mean AIFMs need to put pressure on providers to confirm they are ready!
- Costs (expected to be ~ 2bps for multiple model, subject to minimum fees, paid by the AIF & up to 4 - 5bps for single model?)
- Managed accounts – interaction with depositary across potentially different administrators
- Future considerations (e.g. domicile of depo-lite, ability to act as single depositary).

On-boarding Process

- Many managers face a challenge to become AIFMD ready by early 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
- Depo-lite contracts will be between AIFM, AIF and Depo-lite provider. Contracts should be to a negligence standard only (no capped liability etc.)
- Simple amendment to PB, Custodian and Admin agreements to reflect their performance of depo-lite safe keeping and cash flow monitoring duties, respectively
- Depo-lite model and role of provider(s) will require disclosure in the AIF offering memorandum
- AIFM will need to identify depo-lite providers on VoP application to FCA, and FCA will confirm depo-lite willing to act
- AIFM will need to confirm appropriate due diligence performed on depo-lite in VoP.

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About INDOS Financial

- UK entity established by Bill Prew (ex JCAM COO, Barclays Global Investors European CFO, PwC) in late 2012 to enable EU AIFM of non-EU hedge funds to meet depo-lite requirements
- IFL will provide AIFMD compliant, stand-alone, independent oversight services, using experienced hedge fund professionals with a mix of trustee, controls, & oversight experience
- FCA application for authorisation as an Article 36 Custodian submitted in early June 2013 and recently received “subject to” authorisation from the FCA. Final authorisation anticipated during Q4 2013.
- IFL is entirely independent but working closely with administrators and prime brokers to provide a joined-up and efficient solution to clients
- Robust procedures developed, core staff being hired and systems implemented. We anticipate being fully operational during Q4 2013 –within the expected timeframe of AIFMD authorisation for most existing UK manager VoP applications in early 2014
- Business backed by substantial insurance provided by highly rated financial institution insurers.

About Cummings Law

- Cummings is a boutique law firm specialising in funds and fund management, offering a dedicated, bespoke legal service.
- Cummings offers specialised legal advice for start-ups, existing funds and fund managers.
- Our highly responsive, client-orientated attitude enables us to respond to client needs swiftly and offers a fast turnaround of documents.