

## AIFMD Factsheet: Depositaries

### What is the AIFMD?

The Alternative Investment Fund Managers Directive (“**AIFMD**”) introduces a new passport system for the marketing of alternative investment funds (“**AIFs**”) in the European Union (“**EU**”) and creates a legal framework operating at European level to monitor and supervise alternative investment fund managers (“**AIFMs**”) within a harmonised system for the first time. EU member states were required to transpose the AIFMD into national law by 22 July 2013. A key component of the AIFMD is the clarification and harmonisation of the rules relating to the appointment, functions and liability of depositaries of AIFs.

### Appointment of Depositaries

#### *Depositary Eligibility*

An AIFM must appoint a single depositary in respect of each AIF it manages. The depositary can be an EU credit institution, an EU investment firm, or institutions entitled to act as a UCITS depositary. For non-EU AIFs, the depositary may also be an institution equivalent to an EU credit institution or EU investment firm provided that it is subject to effective prudential regulation (including minimum capital requirements) and supervision having the same effect as EU law. The European Commission has adopted a delegated act containing implementing measures under the AIFMD (the “**Level 2 Regulation**”) which elaborates on the criteria to be applied in assessing third country prudential and supervisory regimes.

In recognition of the fact that private equity and venture capital funds do not rely on third party custodians, the AIFMD provides that EU member states may permit entities which carry out the depositary functions as part of their professional or business activities (eg, law firms, notaries, investment firms) to act as AIF depositaries for AIFs with investment lock up periods of at least five years or that invest in illiquid assets for which custody may not be appropriate.

Depositaries to EU AIFs must be established in the home member state of the AIF. For non-EU AIFs, the depositary should be established either in the home third country of the non-EU AIF, in the home member state of the AIFM, or in a non-EU AIFM’s member state of reference.<sup>1</sup> If the depositary is established in a third country, then in addition to the prudential and supervisory equivalency referred to above, the following requirements apply:

- there must be cooperation, exchange of information and multilateral tax agreements in place between (i) the depositary’s competent authorities and (ii) the competent authorities of any member state into which the AIF is to be marketed and, if different, of the home member state of the AIFM;
- the third country must be Financial Action Task Force compliant; and
- the depositary must contractually agree to the liability standards specified in the AIFMD.

#### *Depositary Contracts*

In every case, there must be a written contract of appointment of the depositary to an AIF. The Level 2 Regulation provides that, if permitted under national law, this can be a framework agreement between an AIFM and the depositary covering all AIFs which the AIFM manages and to which that depositary is appointed.

The Level 2 Regulation prescribes particulars of the contract appointing the depositary, which correspond with the provisions contained in the UCITS management directive (Directive 2010/43/EC), amended as necessary to take into account specific characteristics of the AIFMD (eg, the need to describe the types of assets falling within the safekeeping obligation and the AIFMD specific liability standard

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<sup>1</sup> For further information regarding the member state of reference, see our [AIFMD Factsheet: Member State of Reference](#).

and discharge rules). However, the Level 2 Regulation sensibly stopped short of prescribing a model agreement, given the wide range of funds which are regulated under the AIFMD.

## Functions and Obligations of Depositaries

The depositary serves two broad functions: (1) to safekeep the AIF's assets; and (2) to oversee compliance with the AIF's constitutional documents and with applicable laws and regulation (collectively the "AIF applicable rules"). An obligation on the depositary to monitor the AIF's cashflows is also separately set out in the AIFMD.

### Safekeeping

The duty to safekeep consists of either custody or record keeping depending on the type of asset owned by the AIF.

The Level 2 Regulation provides that the custody function includes proper asset segregation on the depositary's or its delegate's books, due care of assets held in custody and assessment and monitoring of custody risk throughout the custody chain.

The custody function applies to all assets which can be held in custody, whether by physical delivery or by way of registration in a financial instruments account (which must be segregated) in the depositary's books. The Level 2 Regulation addresses the types of financial instrument which should be included in the scope of the depositary's custody function, namely transferable securities, money market instruments and units in collective investment undertakings, which are registered or held directly or indirectly in an account in the name of the depositary. Assets which are subject to re-hypothecation rights remain in custody while the rights of re-use remain unexercised.

All assets which cannot be held in custody are subject to the record keeping obligation. The depositary's obligations as regards such other assets are to maintain up-to-date records and verify ownership (based on such information to be provided by the AIF or AIFM or, if available, external evidence, as the depositary deems necessary to be able to satisfy itself as to ownership, and subject to procedures to ensure such assets cannot be transferred without the depositary or its delegate being informed). In this regard, there is a strong dependency on the ability of the depositary to obtain information from third parties and a corresponding obligation on the AIFM to procure its provision to the depositary.

The Level 2 Regulation also specifies reporting obligations for prime brokers appointed by an AIF or AIFM, imposing the primary obligation on the AIFM to ensure the provision to the depositary of the mandated information.

### Oversight

The oversight, or monitoring, obligations imposed on depositaries will already be familiar to Irish custodians of non-UCITS, mirroring as they do the existing oversight obligations imposed by the Central Bank of Ireland ("**Central Bank**") on the custodians of all Irish authorised funds. These obligations require that depositaries:

- ensure that dealings in units or shares of the AIF are in accordance with the AIF applicable rules;
- ensure unit or share valuation is calculated in accordance with the AIF applicable rules and the valuation principles in the AIFMD;
- carry out the instructions of the AIFM unless they conflict with the AIF applicable rules;
- ensure that in transactions involving the AIF's assets, any consideration is remitted to the AIF within usual time limits; and
- ensure that the AIF's income is applied in accordance with the AIF applicable rules.

The provisions in the Level 2 Regulation acknowledge that, while the processes and procedures for exercising the oversight function should be proportionate to the estimated risks of the relevant AIF and without prejudice to the depositary's ability to conduct appropriate ex-ante verifications, in principle most verification checks will be ex-post second level controls.

### Cash Monitoring

The cash monitoring obligations imposed on depositaries, while not addressed as part of the oversight function, are nonetheless complementary to that function, given that they require the depositary to have a full overview of the cash position and cash movements

of the AIF, including subscription monies. The Level 2 Regulation requires that there be effective implementation and periodic review by the depositary of cash monitoring procedures, in particular as regards reconciliations, and the notification of the AIFM of any identified discrepancies that have not been rectified without undue delay. Of necessity, where cash accounts are in the name of the AIF or the AIFM on behalf of the AIF, the depositary will again be dependent on compliance by the AIFM with its obligations to ensure the provision of timely and accurate information to the depositary.

## Conflicts

An AIFM cannot act as a depositary. A prime broker acting as a counterparty to an AIF is only permitted to act as a depositary if it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker and any potential conflicts of interest are properly identified, managed, monitored and disclosed to the AIF investors.

Depositaries are also under a general obligation to act honestly, fairly, professionally, independently and in the interests of the AIF and its investors. They cannot undertake potentially conflicting activities with regard to an AIF unless there is functional and hierarchical separation between the depositary functions and such other potentially conflicting activities and the potential conflicts are managed, monitored and disclosed to investors.

## Delegation

A depositary may only delegate responsibility for its safekeeping functions to third parties; it cannot delegate its oversight responsibilities. Delegation (and sub-delegation) is subject to a number of conditions, including that an objective reason for the delegation can be demonstrated by the depositary and that the intention behind the delegation is not to avoid the requirements of the AIFMD. The depositary must, as is currently the case under Central Bank rules, exercise “all due skill, care and diligence” in the selection, appointment and ongoing review and monitoring of its delegates and furthermore must ensure that the delegate meets, at all times during the performance of the delegated tasks, certain specified standards (including as regards its expertise, prudential regulation and supervision and as regards segregation of assets).

In circumstances where delegation is required due to third country rules requiring that certain financial instruments be held by a local entity (a “**third country custody requirement**”), but no local entity which meets the prudential regulation and supervision requirements of the AIFMD can be identified, a depositary may still delegate custody provided that the relevant AIF’s investors are duly informed, in advance, of the reasons and justifications for the delegation and the AIF or AIFM on its behalf instructs the depositary to delegate to such local entity. Use of securities settlement systems is not considered to be custody delegation for AIFMD purposes.

The Level 2 Regulation addresses the specific tasks that the depositary is expected to carry out in order to comply with its due diligence duties, based on best market practices and with a particular focus on the consequences of an insolvency of the delegate. These include implementation and regular review of an appropriate documented due diligence procedure which should consider, inter alia, country and custody risk arising from the applicable legal and regulatory framework, the delegate’s internal controls and procedures, its financial strength and reputation, and its operational and technological capabilities. The Level 2 Regulation also clarifies the requirements to ensure that the delegate effectively segregates the assets of the depositary’s clients from its own and the depositary’s assets, with a view to limiting the risks associated with the insolvency of the delegate.

As a general principle, the AIFMD does not make any concessions to a depositary’s position where it has delegated some of its functions and, subject to the limited discharge provisions discussed below, a depositary remains liable for compliance with the AIFMD and its contractual obligations notwithstanding that a loss may have been caused by its delegate.

In December 2014, the European Securities and Markets Authority (“**ESMA**”) published a consultation paper setting out proposals for possible guidelines regarding the asset segregation requirements in the case of delegation of safekeeping duties by the appointed depositary of the AIF. The AIFMD requires that the depositary ensures that the third party delegate segregates the assets of the depositary’s clients from its own assets and from the assets of the depositary in such a way that they can at any time be clearly identified as belonging to clients of a particular depositary.

In its consultation, ESMA sought feedback on two alternative options for meeting this requirement. The first option is that the account in which the AIF’s assets are to be kept by the delegated third party may only comprise assets of the AIF and assets of other AIFs of the same delegating depositary. Under the second option, a delegated third party holding assets for multiple depositary clients would not be required to have separate accounts for the AIF assets of each of the delegating depositaries. The consultation closed on 30 January 2015. This was followed by a call for evidence on asset segregation from ESMA, which was published on 15 July 2016. Finally, on 20 July 2017, ESMA published an opinion to the European Commission, the European Council and the European Parliament

providing suggested clarifications in relation to the asset segregation requirements in the case of delegation of safekeeping duties by the appointed depositary of the AIF.

## Depositary Liability

The AIFMD has introduced significant changes in the approach to depositary liability for custody, in order to address perceived weaknesses in the pre-existing regime. As a result of these changes, a loss by a depositary or its delegate of a financial instrument held in custody will give rise to an obligation to replace the instrument or pay the value to the AIF without undue delay.

A depositary can only avoid this strict liability standard where it can prove, cumulatively, that the loss was as a result of an external event, beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. If the loss has been caused by a delegate, there is a limited ability for the depositary to discharge itself from liability if it can prove, again cumulatively, that:

- it has met all AIFMD requirements relating to delegation;
- the written contract between the depositary and the delegate transfers liability to the delegate and permits either direct enforcement by the AIF, or by the AIFM or depositary on its behalf, against the delegate; and
- the depositary's contract with the AIF (or AIFM on its behalf) expressly allows such a discharge and establishes the objective reason for this.

Finally, where a delegation has arisen due to a third country custody requirement, the depositary can again discharge its liability provided the AIF's constitutional documents expressly allow for a discharge in such circumstances; the delegation requirements associated with a third country custody requirement, identified above, have been met; investors have been pre-advised of the discharge and its justification; and the depositary contract and delegation contract contain, respectively, the required transfer, enforcement and discharge provisions.

Aside from its custody obligations, the AIFMD provides that a depositary will be liable to the AIF or its investors for all losses caused by its negligent or intentional failure to fulfil properly its obligations under the AIFMD.

In terms of enforcement, liability to the investors of the AIF may be invoked either directly or indirectly through the AIFM, depending on the legal relationship between the depositary, the AIFM and the investors.

## Comment

Many of the depositary-related provisions of the AIFMD reflect pre-implementation practice for Irish custodians, who were therefore well positioned to deal with the operational impacts of AIFMD implementation. The introduction of the AIFMD required custodians / depositaries to review and revise their custody contracts and sub-custody agreements to address a number of AIFMD specific issues, including to describe the types of assets falling within the safekeeping obligation, specify information requirements and, not least, reflect the AIFMD specific liability standard and discharge rules.

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