

# MACFARLANES

## FINANCIAL SERVICES

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### BRIEFING

#### **AIFMD - DEPOSITARIES IMPACT ON PRIVATE EQUITY FIRMS**

The Alternative Investment Fund Managers Directive (the Directive) has introduced a number of concepts which will result in private equity firms having to change their procedures. One of these is the introduction of a requirement for all funds to have a depositary (being an independent third party responsible for, among other things, safekeeping assets and monitoring cash flows). Whilst for certain types of fund (e.g. hedge funds) the concept of a depositary may not be far removed from the roles currently split between administrators and prime brokers, for most private equity funds it will make a significant difference to the operation of the funds.

The provisions relating to depositaries were originally a response to the Madoff scandal plus a desire on the part of the regulators to put greater restrictions on the use of a fund's assets. The provisions in the final text of the Directive are, fortunately, considerably less severe than those included in the earlier drafts.

The Directive sets out the proposed functions and responsibilities of a depositary in a broad manner, and will require the manager of an AIF to appoint a depositary which will be responsible for cash monitoring, safe keeping of assets and other oversight responsibilities in relation to each such fund. However, greater details will be set out in the Level 2 provisions which will contain the specific rules to be implemented into national law.

This note sets out an analysis of the provisions of the Directive regarding depositaries which will have most impact on a private equity manager. At a high level, this analysis will still be applicable when the Directive finally comes into force, however, the Level 2 measures are expected to provide significant detail on the various obligations. Although the Directive has not yet been officially published, European Securities and Markets Authority (ESMA, formerly CESR) has already set up various working groups to deal with the different parts of the Directive where more detail is needed, with each working group being chaired by a representative from a different Member State. The chair of the working group on depositaries is France.

This note refers in places to feedback received from the working group looking at depositaries for ESMA (the Working Group). This feedback is not public and, as a result, can only provide a limited indication of the direction in which the details of the implementing measures are heading.

#### **ALTERNATIVE INVESTMENT FUND MANAGERS (AIFMS) AND ALTERNATIVE INVESTMENT FUNDS (AIFs)**

For the purposes of the Directive, most private equity fund managers will be AIFMs. The Directive will impose rules and obligations upon an AIFM in respect of each "AIF" that it manages, so it is important to first establish which fund entities will be an AIF for the purposes of the Directive.

Under Article 4(1)(b), an AIF is any collective investment undertaking, including investment compartments thereof, which is not a UCITS and which "raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors." This definition is likely to include most types of private equity fund vehicles and could potentially include other parts of a fund's structure such as the carry vehicles or a general partner which is established as a limited partnership. The Directive makes distinctions based on where an AIF is established, both for the purposes of whether it is an EU or non-EU AIF, but also in relation to the domicile requirements of the depositary (see below). For the purposes of the Directive, an AIF is established in the state in which it is authorised or registered, or if it is not authorised or registered, the state where it has its registered office.

Despite the wide definition of an AIF, private equity managers should find that some of their funds are excluded from the Directive as a result of the transitional provision at Article 59 of the Directive. The final transposition date of the Directive, i.e. the date on which it must be enforced in the national laws of Member States, is two years from the date on which the Directive is officially published. This has not happened yet, but is currently proposed to be in June 2011. On this basis, the Directive would not come into force until June 2013 (N.B. – the official publication of the Directive was originally scheduled for February 2011, so it is possible that the publication, and therefore the final transposition date, could, in the event, be later than June 2011).

The effect of Article 59 is that a closed-ended AIF which does not make investments after the final transposition date will not be included within the Directive. As a result of this, funds whose investment periods will have ended during or before mid-2013 (and which do not subsequently make any follow-on investments) should be exempt from the Directive and so AIFMs will not have compliance obligations in respect of those funds.

#### **DEPOSITARIES (ARTICLE 21)**

An AIFM will be required to appoint a single depositary for each AIF which it manages for the purposes of the Directive. An AIFM cannot itself act as a depositary. For an EU AIF, the depositary must be either:

- ◆ an EU credit institution;
- ◆ an EU investment firm; or
- ◆ an institution which would be eligible to be a depositary under the UCITS Directive.

For a non-EU AIF the depositary can be a non-EU credit institution or investment firm, provided such entity is subject to equivalent prudential regulation and supervision.

In addition, Article 21(3) provides that member states will allow certain closed-ended funds to have a depositary which is an entity “which carries out depositary functions as part of its professional or business activities and is subject to mandatory professional registration.” This will apply to an AIF which: (i) has no redemption rights exercisable for five years following the date of initial investments; and (ii) does not generally invest in assets that must be held in custody. It is likely that this will apply to most private equity funds.

Recital 24 of the Directive provides further detail on what type of entity could be a depositary within the description above, and these include notaries, lawyers or registrars.

The Directive appears to permit quite a broad range of entities to be depositaries. It does, however, stipulate that depositaries must be liable to both the AIF and its investors for the loss of any financial instruments held in custody by it. A depositary may delegate certain of its functions, including its safekeeping responsibilities, however it will remain liable for those assets (unless certain strict criteria are met). As a result of this liability and the high level of responsibility (and subsequent risk) which it appears that a depositary will be obliged to take on, it is unclear which entities will actually be willing to take on the role and, perhaps more importantly, how they will charge to provide the service they are expected to provide. It seems unlikely that existing administrators will be willing to become depositaries. A private equity fund manager must therefore consider whether it would prefer an entity to take on the role of both depositary and administrator.

#### **DOMICILE OF THE DEPOSITARY (ARTICLE 21(5))**

For an EU AIF, its depositary must be established in the same Member State as the AIF. For non-EU AIF, the depositary must be established either in the same country as the AIF, or the home (or reference) member state of the AIFM. Under the Directive, a depositary will be “established” in the state where it has its registered office or branch.

For private equity funds with more complex structures (i.e. with parallel funds in alternative jurisdictions), the most detrimental potential effect of these provisions is the possibility that each of the vehicles within a fund structure will be treated as a separate AIF and as a result the AIFM may need to appoint, for example, an English depositary for an English fund vehicle, a French depositary for a French fund vehicle and so on.

#### **RESPONSIBILITIES OF A DEPOSITARY**

Once it is established which AIF will require a depositary and who that depositary should be, consideration must be given as to which functions the depositary will have to carry out on behalf of the AIF. Under the Directive, the depositary’s responsibilities will broadly be:

- ◆ cash monitoring (Article 21(6));
- ◆ safekeeping of assets (Article 21(7)); and
- ◆ a number of other oversight functions, including ensuring that valuation and dealing in interests of the AIF are carried out in accordance with applicable law and the constitution of the AIF (Article 21(8)).

#### **1 CASH MONITORING**

Under Article 21(6), the depositary must ensure that the AIF’s cash flows are properly monitored and that all payments from or on behalf of investors into an AIF are properly booked into cash accounts.

There is concern that, in the case of private equity funds, the Directive is effectively creating an additional step, and counterparty, between the GP/Manager deciding to drawdown and the requests being made to investors. While many hedge funds have administrators which effectively already perform this role (albeit with less oversight), it does not fit in with the way private equity funds currently operate.

It would appear from feedback from the Working Group that the Level 2 measures will look to define the depositary's role as "ex post" monitoring of cash flows which should be akin to an auditing function. If this turns out to be the case, then a depositary will not need to be actively involved in closings or making draw-down requests.

## **2 SAFEKEEPING OF ASSETS**

Under Article 21(7), the depositary is made responsible for the safe keeping of the AIF's assets. Assets are divided into two categories: assets which can be "held in custody" which must be held in a financial instruments account in the books of the depositary; and all other assets, for which the depositary must verify the AIF's ownership and maintain a record thereof.

The Directive does not specify what types of assets can be "held in custody", but feedback from the Working Group suggests that this will be transferable securities, money market instruments and units of collective investment schemes as set out in MiFID.

It appears therefore, that investments of the type made by private equity funds will in most cases be classified as "other assets" for these purposes. As a result, there should not be a requirement for assets to be held by the depositary. It is not clear whether the assets will instead have to be held in the name of the AIF. In any event, the depositary will have to verify the AIF's ownership of those assets by reviewing the formal documentation. Since the assets of a private equity fund will usually be shares in, or loans to, a private company or similar, this function should be relatively simple to achieve.

Some private equity funds' investments are registered in the name of a custodian. If legal title is not needed to be held by the depositary or in the name of the AIF then this arrangement could continue. If legal title must be held by the depositary then it will be necessary to determine whether the existing custodian could perform the role of depositary or whether alternative arrangements will be required. If legal title must be held by the AIF directly then alternative arrangements are likely to be necessary.

## **3 OVERSIGHT RESPONSIBILITIES**

Article 21(8) sets out the remainder of the depositary's responsibilities under the Directive which are, broadly speaking, additional oversight responsibilities. The depositary will have to ensure that valuations and dealing in interests in the AIF are carried out in accordance with the Directive, national law and the AIF's constitution. The depositary must also ensure that an AIF's income is applied in accordance with national law and the AIF's constitution.

There is a concern that, as with the cash monitoring, a depositary would need to be involved in all transactions, whether receiving initial commitments, requesting draw-downs, making investments or repaying commitments and duplicating the auditors' role in relation to confirming compliance with an AIF's constitutional documents. However, the feedback from the Working Group suggests that the depositary's oversight functions should also be performed "ex post". In relation to dealing in LP interests, it is suggested that this will involve the depositary checking that the AIFM has proper procedures in place for reconciling interests created or cancelled and then verifying, on a regular basis, that these procedures are effective. Similar requirements would presumably apply in relation to transfers of partnership interests.

One of the other oversight responsibilities will be to ensure that the AIF's valuation procedures comply with the Directive, as well as national law and the AIF's constitution. The concern here is that if it is not applied proportionately, the Directive could cause the AIFM of a private equity fund to have to change its valuation procedures, notwithstanding that these procedures already follow established guidelines (e.g. the joint BVCA/EVCA/AFIC international valuation guidelines) and have already been agreed with investors. It is hoped that the Working Group will take a sensible and proportionate approach, such that the depositary is only required to check the audits on valuation policies and only intervene where there are grounds for believing that the AIF or the AIFM is acting in contradiction to national law or the AIF's constitution. Unfortunately, the feedback received from the Working Group has not yet provided further detail on this point.

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