The Role of the Depositary under the AIFMD and the AIF Rulebook

One of the primary stated aims of the Alternative Investment Fund Managers Directive¹ (AIFMD) was to increase investor protection². A key step in this regard was the imposition of a standard requirement that alternative investment fund managers (AIFMs) falling within the scope of the AIFMD and marketing their funds into Europe ensure each relevant alternative investment fund (AIF) which they manage appoints a third party depositary with respect to its underlying assets³.

The general principles relating to the appointment, role and duties of depositaries pursuant to the AIFMD have now been supplemented by the additional measures contained in a “Level 2” Regulation approved by the European Commission⁴. In addition in Ireland, the primary European jurisdiction for the servicing and domiciliation of alternative investment funds⁴ the relevant regulator, the Central Bank of Ireland (the Central Bank”) has now issued its “AIF Rulebook” which includes a specific chapter detailing the requirements relating to depositaries in Ireland under the AIFMD⁵.

This article explores the specific requirements pertaining to the appointment of depositaries reflected in this body of legislation, as well as their duties and responsibilities once appointed, and highlights the legal documentation which will be required to ensure compliance.

¹ Directive 2011/61/EU
² Recital 3 Directive 2011/61/EU
³ Article 21 Directive 2011/61/EU. It can be noted that, subject to the applicable conditions, this requirement does not apply under Article 34 Directive 2011/61/EU to Non-EU domiciled funds which are not marketed into the EU. See “The ‘Depositary Lite’ Regime” below for more.
⁴ In excess of 40% of global alternative funds are administered in Ireland. See http://www.irishfunds.ie/statistics/23-total-assets-administered-in-ireland/ for further details
⁵ The AIF Rulebook was issued on 15 May 20113. Chapter 6 is entitled “AIF Depository Requirements
Background and Legislative Overview

The AIFMD was prepared in response to the market difficulties experienced as a result of the financial crisis of 2007/8. A primary concern was that the activities of AIFMs may spread or amplify risks through the financial system. Accordingly the AIFMD was drafted to provide comprehensive common arrangements for supervision of AIFMs at the European level.

The AIFMD was prepared as a principle-based framework document under the ‘Lamfalussy Process’ and as such, following its adoption, much of the fine detail, including with respect to the appointment, duties and potential liability of the depositary remained to be determined as ‘Level 2’ measures. The finalised text relating to Level 2 was contained in a regulation which was approved by the Commission on 19 December 2012 (the ‘Regulation’). The specific provisions relating to depositary liability to be contained in the Regulation were a key concern as draft text prepared for this by the European Commission, caused concern that the liability standard would be so high as to require a significant increase in custody fees and to potentially lead to key industry players determining to abandon the market. The final text approved had been amended from this earlier more onerous draft, however, although the liability standard applicable is higher than would typically be the case at present where a custodian has been appointed to an EU alternative fund7.

The Regulation itself has now been sent to the European Parliament and Council for approval and, as it is not expected to be opposed, should receive their approval in April 2013.

Overview of Depositary Provisions

The AIFMD does not purport to regulate AIFs directly. Accordingly it does not require AIFs to appoint a depositary (except where the AIF also constitutes the AIFMD, as is the case, for example, with self-managed investment companies) but rather imposes the requirement upon the relevant AIFM to ensure that a depositary is appointed to AIFs it manages8. Notwithstanding the indirect nature of this practical obligation, the AIFMD does contain a series of requirements pertaining to:

- the manner of appointment of the depositary;
- the types of entity which may or may not be appointed in satisfaction of this obligation (including their domicile);
- the duties and potential liability inherent in this role; and
- the extent to which aspects of it can be delegated, including the effect of this with respect to the potential liability of the depositary9.

The Regulation further details the requirements applicable to these points9, and in particular in relation to: the content of the contract appointing the depositaries10; the criteria for assessing the regulation of depositaries in third countries11; depositary functions and duties12; liability of the depositary13 and contracts discharging this14.

Contractual Arrangements

The AIFMD itself provides that a depositary be appointed by written contract which ensures that the depositary can receive adequate information under the terms of this agreement to enable it to carry out its functions15. This obligation is elaborated on substantially in the Regulation which details over 20 specific terms to be included in such contracts.

Most of the required inclusions relate to points which will generally already be addressed under existing custody agreements, where these are in place, such

---

7 As mentioned above, AIFMs will not be subject to this requirement of the AIFMD where they are managing non-EU AIFs which are not marketed into the EU.
8 Section 4, Article 21 Directive 2011/61/EU
9 Chapter IV Directive 2011/61/EU
10 Article 83 Regulation
11 Article 84 Regulation
12 Articles 85-99 Regulation
13 Article 100 Regulation
14 Article 102 Regulation
15 Article 21 (2) Directive 2011/61/EU

---

See “Liability Standard “below for more
as those pertaining to Irish regulated alternative funds such as qualifying investor funds (‘QIFs’). However, specific aspects will typically require additional elaboration. For example, the requirement to state the procedures to be adopted for each type of asset\textsuperscript{16} and the description of the manner in which the oversight function is to be performed depending on asset type and the relevant geographical region of the investment\textsuperscript{17}.

Accordingly, depositaries will be obliged to revise their standard contracts and range of services to observe their increased obligations under the AIFMD, as well as the applicable liability standard. Existing EU AIFs with depositaries will need to amend their contracts to ensure compliance with this new regulatory environment and AIFMs which fall under the scope of the Directive will need to ensure appropriate new contractual arrangements are put in place.

**Nature and location of the depositary**

The AIFMD itself specifies the range of institutions which may serve as the depositary to an AIF\textsuperscript{18} and provides that AIFMs are excluded from acting in such capacity for AIFs they manage\textsuperscript{19}. It also provides for the location of the relevant depositary based on the domicile of the AIF, being that of the AIF’s domicile for EU structures, which has also been the general regulatory requirement applicable in European countries to date. As a depositary located in a non-EU Member State may also qualify as a valid selection under the AIFMD with respect to non-EU AIFs, subject to applicable conditions, a range of criteria for assessing whether such an entity is acceptable for the purposes of the AIFMD are included in this directive and elaborated upon in the Regulation. Non-EU AIFs (only) will in fact be afforded an element of choice of location for their depositary\textsuperscript{20}, including in the country where the relevant AIF is located but also potentially the relevant AIFM’s home state or its Member State of reference\textsuperscript{21}.

This latter is defined as one of the Member States in which one non-EU AIF is marketed, or, where an AIFM markets several AIFs, the Member State where it intends developing effective marketing for most of the AIFs\textsuperscript{22}. For larger non-EU managers this may mean that the presence of a local custody industry would be a key consideration when determining where to situate their European distribution operation. In Ireland the Central Bank’s AIF Rulebook further details the eligibility conditions for depositaries\textsuperscript{23}. Requirements for entities in the jurisdiction include an obligation to appoint a minimum of two Irish resident directors and to have minimum capital of the higher of at least €125,000 or one quarter of its total expenditure taken from its most recent annual accounts\textsuperscript{24}.

Depositaries located in non-EU countries will only be acceptable for the purposes of the AIFMD where

(i) the entity itself meets the relevant criteria, by being subject to effective regulation\textsuperscript{25} and contractual obligations\textsuperscript{26} similar to those applicable to EU depositaries, for example, and

(ii) the country in which it is located meets the relevant criteria set out in the AIFMD by virtue of, for example, the existence of a cooperation agreement between its competent authorities with those of the relevant EU Member States\textsuperscript{27} and the fact that it is not listed by FATF as a non-cooperative Country and Territory\textsuperscript{28}, for example.

\begin{itemize}
  \item \textsuperscript{16} Article 83 (1) (a) Regulation
  \item \textsuperscript{17} Article 83 (1) (b) Regulation
  \item \textsuperscript{18} Article 21 (3) Directive 2011/61/EU
  \item \textsuperscript{19} Article 21 (4) Directive 2011/61/EU
  \item \textsuperscript{20} Article 21 (5) (b) Directive 2011/61/EU
  \item \textsuperscript{21} Article 21 (5) (b) Directive 2011/61/EU
  \item \textsuperscript{22} Article 37 (4) Directive 2011/61/EU
  \item \textsuperscript{23} "AIF Depositary Requirements", Chapter 6, AIF Rulebook
  \item \textsuperscript{24} ii (1)(a) and ii (1) (c) Chapter 6, AIF Rulebook
  \item \textsuperscript{25} Article 21 (6) (b) Directive 2011/61/EU
  \item \textsuperscript{26} Article 21 (6) (e) Directive 2011/61/EU
  \item \textsuperscript{27} Article 21 (6) (a) Directive 2011/61/EU
  \item \textsuperscript{28} Article 21 (6) (c) Directive 2011/61/EU
\end{itemize}
Detailed criteria for assessing whether the level of prudential regulation and supervision of a depositary in a third country is adequate for the purposes of the AIFMD are included in the Regulation. These conditions also include requirements relating to base capital, legal obligations and applicable operating conditions of the depositary. It remains to be seen which countries will be deemed acceptable for such purposes going forward, although the European Securities and Markets Authority ("ESMA") has announced that it is in negotiations with IOSCO member countries and in January 2013 it approved the entry into a Memorandum of Understanding with the Brazilian regulatory authority, the Comissão de Valores Mobiliários.

Although the appointment of a third party depositary to non-EU AIFs is not currently prevalent, the appointment of prime brokers is very common. Accordingly it is worth noting that the AIFMD provides that, in order to avoid conflicts of interest, a prime broker would be prohibited from acting as depositary to an AIF to which it has been appointed unless it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker and the potential conflicts of interest are properly identified, managed, monitored and disclosed. This may prompt prime brokers to restructure their operations to ensure that they can meet these requirements or to reconfigure the nature of their contractual relationship with the AIF so that they only act as counterparties. Where prime brokers are appointed they are subject to specific reporting obligations to the depositary under the AIFMD.

**Duties of the Depositary**

The AIFMD imposes specific duties on the depositary. These include general overriding obligations as well as more specific duties related to their functional role. The former include duties to act 'honestly, fairly, professionally, independently', to act in the interests of relevant AIFs and their investors and to avoid conflicts of interest. On the other hand, specific functional duties include:

- obligations to safeguard or otherwise verify ownership of AIF assets;
- to monitor cash flows in respect of the AIF;
- to ensure transactions relating to units in the AIF are carried out in accordance with fund documentation;
- that appropriate valuations are applied;
- that management instructions are carried out;
- that consideration for AIF assets is received in normal timeframes; and
- that its income is applied appropriately.

These duties have been elaborated upon in the Level 2 Regulations to give further specific practical guidance on what is required to comply with the applicable obligations, in particular with respect to types of financial instruments to be held subject to custody duties, the potential use of a central depositary and instruments issued in nominative form.

It can be noted that many of these duties are similar to the existing requirements imposed by the Central Bank of Ireland on non-UCITS funds. This means that while amendments will typically be required to the custody...
agreements applicable to existing Irish non-UCITS, such as QIFs, once the AIFMD becomes effective and while this will result in amendments to the existing arrangements and practices of Irish custodians, these will generally not involve an unduly extensive level of additional work. It also means that Irish based custodians are ideally equipped to service non-Irish AIFs appointing depositaries for the first time, where they can satisfy the necessary criteria for the location of the relevant depositary. It can be noted that the primary additional duties include the specific new obligations regarding the requirements on the depositary with regard to cash monitoring (including opening of accounts) and ensuring all subscription payments have in fact been received. The AIF Rulebook also specifically details the tasks and operating conditions applicable to depositaries in Ireland. Among these are a specific obligation to notify the Central Bank of any material breach of applicable legislation (including the AIFMD), to ensure that it does not have directors in common with the board of an AIFM it provides services to and to decline to permit performance fees to be paid until these have been verified by the depositary or an entity it has approved.

Delegation

The AIFMD prohibits delegation by a depositary of its duties, except those relating to safe-keeping or verification of ownership of assets. In practice this permits the establishment of an effective sub-custody network while ensuring that the duly appointed depositary does retain primary responsibility (and liability). In addition, delegation, to the limited extent that it is permitted, is subject to a series of conditions. These include that there is an objective reason for the delegation and that it is not being undertaken in a bid to avoid the requirements of the AIFMD.

The depositary must exercise skill, care and diligence in both the initial selection of delegates and also their periodic review and on-going monitoring. This involves an on-going obligation to ensure that the delegate complies with the applicable requirements, which include that it be regulated, have adequate structures and expertise, ensure assets are segregated and undertake to comply with the general requirements applicable to the depositary. Depositaries will accordingly be obliged to undertake a thorough due diligence on their network of sub-custodians to ensure that they meet the relevant requirements and in addition they will be obliged to put in place an effective system for on-going monitoring and review to maintain compliance. The Regulation includes a series of steps to be carried out at a minimum in order for a depositary to be deemed to have satisfied its obligations in this regard.

Assets belonging to an AIF may not be excluded from the scope of the custody obligation where they are subject to particular business transactions such as collateral arrangements. Therefore, where an AIF provides its assets as collateral to a collateral taker, the AIFMD does require these assets to be kept in custody as long as the AIF owns the financial instruments.

In order to meet these requirements a number of practical solutions are possible under the AIFMD, for example: (1) the collateral taker could act as the depositary of the AIF or be appointed by the AIF’s depositary as sub-custodian over the relevant assets; (2) the AIF’s depositary could appoint a sub-custodian that acts on behalf of the collateral taker; or (3) the collateralised assets could remain with the AIF’s depositary but be ‘earmarked’ in favour of the collateral taker.

While each of these potential solutions would be possible, clearly ensuring compliance under the AIFMD would entail various challenges in each scenario.

---

37 i.e. a non-EU AIF whose Member State of Reference is Ireland or whose AIFM is based in Ireland
38 iii Chapter 6, AIF Rulebook
39 iv Chapter 6, AIF Rulebook
40 iii (2) Chapter 6, AIF Rulebook
41 iv (1) Chapter 6, AIF Rulebook
42 iv (5) Chapter 6, AIF Rulebook
43 Article 21 (11) Directive 2011/61/EU
44 In accordance with Article 21 (13) Directive 2011/61/EU the liability of a depositary is in general not affected by the delegation of its functions. This is addressed in greater detail under “Liability” below and the exceptions are explored.
45 Article 21 (11) Directive 2011/61/EU
46 Article 98 Regulation
This will be particularly the case where the AIF wishes to avail of prime brokerage services. While, as noted above, prime brokers may be appointed as depositaries subject to the applicable requirements, it is likely that in practice their role will generally instead involve either (1) a contractual relationship with a separate depositary whereby the prime broker will act as a sub-custodian or otherwise as part of the custody network of the depositary, or alternatively (2) the prime broker will be entirely outside this network and effectively act as the counterparty to the AIF. The former models are further complicated by the relevant liability provisions, discussed below, which may lead the depositary to either seek an indemnity from the prime broker or to ensure that the arrangement is structured in the necessary manner to discharge it from liability under the AIFMD\(^ \text{47} \). In Ireland, the AIF Rulebook provides that functions which have not been validly delegated in accordance with the AIFMD must be carried out in Ireland\(^ \text{48} \).

**Liability**

The AIFMD specifies a strict standard of liability for depositaries to AIFs or their investors for instruments held in custody by them and provides that they will be liable for the negligent or intentional failure to properly fulfil their obligations\(^ \text{49} \).

Furthermore, it provides that the liability of a depositary shall not be affected by any delegation of its functions\(^ \text{50} \).

However, where a delegate is responsible for the loss of a financial instrument the depositary can avoid any liability where it has put in place the delegation in accordance with the relevant requirements; the terms appointing the depositary provide for the potential for it to discharge its liability in such a scenario; and where the terms of the delegation agreement expressly provide for the transfer of liability to the delegate while making it possible for the AIF or the AIFM or the depositary itself, in either case acting on its behalf, to make a claim against the delegate\(^ \text{51} \).

It can be noted that the doctrine of privity of contract, which provides that a party which is not a party to a contract may not act upon it, applies in Ireland. In practice therefore it may be useful to join either the AIFM or the AIF as parties to delegation agreements if an Irish depositary is to take advantage of this potential to avoid liability for its delegates yet minimise potential involvement in litigation.

The legislation does make allowance for “force majeure” type events by providing an exclusion from liability where a financial instrument is lost 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”\(^ \text{52} \).

These general provisions regarding liability are further elaborated upon in the Regulation and were one of the key areas of focus in its preparation due to their potential impact upon the structure and composition of the funds industry if a standard which was viewed as unduly burdensome was to be placed upon custodians acting as depositaries. These include provisions addressing the key factors determining the circumstances under which the liability of the depositary is discharged, the nature and effects of the loss of an AIF’s Financial Instruments and valid “Objective Reasons” for contracting the discharge of liability\(^ \text{53} \). Interestingly it can be noted that the requirement for an objective reason for discharging liability will be deemed to be met where the depositary issues warnings on the “increased risk” an investment in a particular jurisdiction poses and the AIFM insists on maintaining such an investment\(^ \text{54} \).

---

\(^{47}\) Article 21 (13) Directive 2011/61/EU  
\(^{48}\) V (1) Chapter 6, AIF Rulebook  
\(^{49}\) Article 21 (12) Directive 2011/61/EU  
\(^{50}\) Article 21 (13) Directive 2011/61/EU  
\(^{51}\) Article 21 (13) Directive 2011/61/EU  
\(^{52}\) Article 21 (12) Directive 2011/61/EU  
\(^{53}\) Chapter IV, Section 4 Regulations  
\(^{54}\) Article 102 (b) Regulation
In Ireland, the Central Bank has clarified that the previous general liability standard of “negligence, fraud, bad faith, wilful default or recklessness in the performance” of its duties will continue to apply for AIFs launched after July 2013 where the AIFM is a “registered” AIFM, i.e. one which only provides services to AIFs which fall under the threshold size\textsuperscript{55}. The following section is also relevant in this regard:

**Exemptions & ‘Depositary-Lite’ Regime and the AIF Rulebook**

AIFMs are permitted to manage non-EU AIFs which are not marketed into the EU provided that (1) there are appropriate co-operation arrangements between the respective competent authorities of the AIF and AIFM and (2) the other requirements of the AIFMD, except those pertaining to the appointment of a depositary and the contents of the AIF’s annual report, are complied with\textsuperscript{56}. It remains to be seen which non-EU jurisdictions will be able to enter into appropriate co-operation arrangements as required and a common framework will be adopted to facilitate the establishment of such co-operation arrangements\textsuperscript{57}.

Furthermore, non-EU AIFs managed by EU AIFMs may be marketed to professional investors in individual EU Member States, if permitted by the national law there, provided that the non-EU domicile of the AIF meets the relevant requirements under the AIFMD (i.e., that it is not listed as a Non-Cooperative Country and Territory by FATF and that appropriate co-operation arrangements providing for information exchange between the competent authorities of both the AIFM and AIF exist) and the AIFM itself complies with the requirements of the AIFMD, except in relation to the appointment of a depositary\textsuperscript{58}. However, in such circumstances the AIFM shall still be subject to an obligation to ensure that a third party (i.e., other than the AIFM) provides certain of the depositary services generally required under the AIFMD, albeit without all of the ancillary requirements\textsuperscript{59} - the so-called “depositary-lite” regime. These required services include monitoring cash flows\textsuperscript{60}, safe-keeping\textsuperscript{61} and general oversight\textsuperscript{62}.

It may be possible for such services to be provided by existing service providers to a fund, such as a prime broker and/ or fund administrator, in whole or in part, thereby removing or limiting the practical obligation to appoint a separate entity as a depositary. This will depend upon both the terms of the authorisation of such service providers and the local legislation to which they are subject, as well as the adoption and interpretation of these provisions in the local law of the Member State.

**Future Developments**

The AIFMD itself will be effective from 22 July 2013. The Regulation will not require any transposition into Member State law once approved as it will be directly applicable. It can be noted that the Central Bank announced that it would begin accepting applications from AIFMs on 15 May 2013, the first European jurisdiction to do so, in order to ensure that AIFMs which wished to avail of the new marketing passport would be able to do so without delay.

The large body of custodian banks which are already well-established in Ireland have a wealth of experience in delivering relevant solutions while subject to duties which are to a significant degree similar to those imposed by the AIFMD. This means that, as a jurisdiction, Ireland is ideally placed to take advantage of the requirement for a depositary to be located in the same jurisdiction as any EU AIF to which it is providing services. It is anticipated that Ireland, which is already the leading European domicile for alternative funds, will see significantly increased growth in this sector in the coming years as international investment managers seek to take advantage of the new pan-European passport which will become available to AIFs under the AIFMD.

\textsuperscript{55} Vi (2) Chapter 6, AIF Rulebook
\textsuperscript{56} Article 34 Directive 2011/61/EU
\textsuperscript{57} Article 34 (2) Directive 2011/61/EU
\textsuperscript{58} Article 36 Directive 2011/61/EU
\textsuperscript{59} Article 36 1 (a) Directive 2011/61/EU
\textsuperscript{60} Article 21 (7) Directive 2011/61/EU
\textsuperscript{61} Article 21 (8) Directive 2011/61/EU
\textsuperscript{62} Article 21 (9) Directive 2011/61/EU
How Mason Hayes & Curran Can Help

Mason Hayes & Curran is a full service, business law firm with 65 partners and over 300 employees specialising in Irish law. With offices in Dublin, London and New York the firm delivers sophisticated legal services to an extensive Irish and international client base. Our investment funds lawyers have a wealth of experience in the investment funds industry and have been involved in the development of policy and regulation in Ireland. We advise on the establishment and on-going operation of Irish domiciled investment funds, including those in the alternative market sectors, and regularly issue client updates on relevant issues. Our dedicated team of investment funds lawyers can also draw upon the expertise of specialist lawyers from our tax, corporate, banking, litigation, intellectual property, data protection, regulatory and compliance practices whenever required to ensure a comprehensive service.

About the Author

Mark Browne is a partner practising in the Financial Services Department. A member of the Investment Funds Unit, he has over 10 years’ experience in the funds industry and advises on all aspects of the structuring, establishment and on-going operation of investment funds in Ireland. Mark practised as an Attorney-at-Law specialising in hedge funds in the funds practice of a leading firm in the Cayman Islands for four years and advises on the redomiciliation of offshore funds to Ireland.

Mark Browne
Partner, Investment Funds

t +353 1 614 5866
e mbrowne@mhc.ie