J.P.Morgan

INVESTOR SERVICES

AIFMD
Depositary Liability - Perspectives

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Introduction

The alternatives industry has long expressed concerns that the introduction of an unusually broad liability regime for fund depositaries – initially under the Alternative Investment Fund Managers Directive (AIFMD) – will compel changes to business practices that could prove problematic. As the 22 July 2013 deadline approaches for implementation of the AIFM Directive, it's apparent that many changes remain to be made across the industry - particularly in relation to the custodial arrangements that need to be in place to allow prime brokers to act as delegates of the safekeeping function assigned to depositaries under the Directive. As expected by the industry, challenges arise from the tension between the extensive legal liability allocated to depositaries for the return of financial instruments and physical assets held in custody, and the practical need for prime brokers to hold those assets in custody in order to efficiently deliver the services they provide.

As an organisation which provides market-leading Prime Brokerage, Depositary, Global Custody and Fund Administration services, J.P. Morgan has sight of these challenges from a number of different perspectives. This client briefing aims to describe some of the key issues from the perspective of two primary stakeholders: the depositary and the prime broker. A summary of the key points raised in this briefing is set out below. We have assumed that the reader is familiar with the AIFM Directive. Readers seeking background to the new rules might wish to consult the excellent summaries produced by some of the major professional services firms.

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KEY CHALLENGES TO CURRENT PRACTICES

The challenges arising from the practical implementation of the AIFM Directive include the following:

1. If a depositary is exposed to the risk that a prime broker will not be able to perform the custodial functions delegated to them, including the return of financial instruments, then the depositary has to account for this risk or mitigate it. Either approach might have additional cost and operational considerations for funds.

2. Although industry practices have evolved to support the appointment of multiple prime brokers for a given fund, the risk assessments and operational requirements of depositaries are expected to become important factors in the selection of prime broker panel firms. Prime brokers with operating models or business characteristics that do not meet the requirements of depositaries might not be entrusted with custody of fund assets by depositaries.

3. The legislation applies in respect of delegates based outside of the EU/EEA, but domestic laws applicable to such delegates might come into conflict with the Directive. For example, depositaries are presented with a challenge when an SEC-registered, US-domiciled prime broker is appointed for a fund, because the Securities Investor Protection Act (SIPA) rules in the US address investor protection in a manner (i.e. the pooling of risks of loss) that is not anticipated by the European legislation.

4. Although the Directive anticipates a more limited set of depositary requirements for AIFs based and managed outside of the EU/EEA, at least in the initial period of its application, product offerings by depositaries do not always differentiate between these (ex EU/EEA) and other AIFs. The reasons for this are partially risk-based and partially operational, but it means there is a growing risk that offshore funds might not be able to avail themselves of the so-called 'Depo Light' model in practice (depending upon their choice of depositary).

5. In order to manage the risks they are exposed to, some depositaries are indicating that they will only be able to accept appointments for funds if fund administration is performed by the depositary's affiliated business. A driver for these combined arrangements is the ability to leverage the systems, processes and skills which are the mainstay of fund administration, in order to support the new oversight functions assigned to the depositary. The costs of separate depositary and fund administration arrangements might be higher, in the absence of synergistic effects.

6. Similarly, when a depositary is able to appoint an affiliated prime broker as a delegate of its custodial function, it is expected that, while applying the same rigorous standards of oversight that must be applied to all delegates, the depositary will be able to realize synergies through, for example, common approaches to network management through the custody chain.

7. The practical challenges of prime brokers acting as subcustodians to depositaries under the new rules are substantial. Prime brokers generally act as global custodians, as well as financial counterparties, and their operating, credit and risk models have been built around performing both functions. Changes to the custodial function are expected to impact upon such models, with subsequent changes to costs and potentially fees.

8. Depositaries who delegate custody to prime brokers are expected to seek indemnities from the prime brokers to mitigate the risk of loss of assets by the prime broker or its subcustodians. Such arrangements might come with additional costs – managers should understand the implications of this.

9. In order to protect investors from the risks of default at the level of a prime broker or its subcustodian, depositaries are expected to seek the ability to transfer fund assets from the custody of a prime broker, or its subcustodian, to another person, should the depositary have concerns about the continuing ability of the prime broker or its subcustodian. The mechanism by which such a change could be made quickly and without disruption to the fund has not yet been determined.

10. The Directive provides for the transfer of part of the depositary's liability (i.e. in respect of the restitution of lost assets) to a delegate of its custodial responsibility, but the conditions in which such a "discharge" will be effective are unclear. In the absence of consistent rules, there is a risk that regulators or the courts might determine that liability should properly be retained by the depositary, notwithstanding a contractual arrangement made with full disclosure to fund investors and the approval of the fund manager. Such a risk undermines the ability of industry participants to make the most effective use of the Directive's provisions, by matching legal responsibility for assets with the practical responsibility for safekeeping.

DEPOSITARY PERSPECTIVES

In order to address the new requirements for the protection of investors, while managing the risks associated with the transfer of liability to depositaries, a number of options are being considered by the depositary industry. The following are some of the approaches under review:

1. Prime Brokers – The AIFMD allows the depositary to delegate custody to a prime broker, in line with current practices. However, by assigning the liability to return assets which might be "lost" by a custody delegate to depositaries, and making depositaries treat prime brokers as delegates, depositaries will be exposed to the risk of significant financial losses, should a prime broker or its subcustodian be unable to return assets which are held in custody. Consequently, depositaries are expected to prefer that fund assets are held in their own accounts and those of its network of subcustodians. When depositaries allow prime brokers to hold assets, they are expected to prefer that AIFMs only appoint "top tier" prime brokers with a strong credit profile and the ability to support operating models required by depositaries. This could result in the realignment of prime broker panels, in order to accommodate new considerations raised by depositaries.

   By delegating custody to a prime broker, the depositary will incur additional costs; this includes the review and evaluation of the subcustody network of the prime brokers, both initially, and as part of its ongoing responsibility to monitor the performance of subcustodians. These costs will increase with the complexity of multi-prime broker arrangements.

   AIFMs who currently use, or are thinking of appointing, a prime broker which is not satisfactory to the depositary might find that depositaries are unwilling to allow that prime broker to act as a custodian for the relevant assets. In this situation, assets will be

held in an account with the depositary and any current operating model with those prime brokers may become more complex. This will likely introduce operational issues for the manager - particularly in a multi-prime broker model, where some assets will be held with prime brokers and other assets will be held in a custody account at the depositary. Further, the assessment of prime brokers will be a unique process for each depositary; a prime broker regarded as acceptable for custody delegation by one depositary may be viewed differently by another depositary.

The risk that fund assets will be lost, after they have been entrusted to a prime broker, is addressed in the Directive by making the depositary liable for their return; however, depositary fees are not historically commensurate with the level of financial exposure being transferred to depositaries. There is a misalignment of risk exposure and economic incentives, which makes the risk more problematic than necessary. Because it cannot be easily modelled, measured and quantified, the risk is difficult to size and price.

2. US Prime Brokers– industry convention is for US-based prime brokers to conduct their business from an SEC-registered broker-dealer, and customer assets held by that broker-dealer will enjoy protection under SIPA. One of the benefits of SIPA is that a trustee in bankruptcy is appointed specifically for the timely return of assets held in a custody account to the beneficial owner, if possible. Under the relevant rules, the US prime broker is required to ensure assets are correctly registered to avoid any shortfall upon disbursement. However, should there be a shortfall, SIPA provides for the spreading of resulting losses by liquidating client positions and making a pro-rata adjustment to the amount returned. Under AIFMD, the depositary may be liable to the investors in the fund to make up any shortfall. As a consequence and due to the added complexity of dealing with the SIPA trustee, it is unclear at this stage whether all depositaries are willing to act as depositary in the context of a US prime broker which would be subject to the SIPA regime.

3. 'Depo Light'– For an interim period, before the full AIFM Directive applies in relation to certain non-EU/EEA AIFs being marketed in the EU/EEA, the full depositary regime will not apply. The view from these managers is that they intend to make a one-time appointment of a depositary that is operationally robust, has a strong balance sheet, and capable of undertaking both 'Depo Light' and full AIFM Directive depositary functions, as needed. Some depositaries view the resources required and associated risk with performing both functions to be functionally equivalent; as a result, they expect to document, deliver and charge for a 'Depo Light' service as if it was a full AIFM Directive arrangement. This reasoning is based on the fact that depositaries cannot easily set up different operating models for different clients, based only on an assessment of the risks associated with their restitution duty. The impact for managers is that they should not automatically expect a simplified process or lower costs for appointing a 'Depo Light' service rather than a full AIFM Directive depositary arrangement.

4. Depositary and Administrator – The AIFMD imposes several key functions on depositaries, which to some extent, are currently conducted by the fund administrator (including but not limited to cash monitoring, subscription monitoring, record keeping and aspects of the verification of ownership of non-custody assets). These requirements do not replace those conducted by fund administrators for other purposes; rather, depositaries will need to replicate these processes, which will have a cost implication for depositaries and which

may be passed on to the AIF. Given the substantial fiduciary responsibilities attached to the depositary, it is no surprise that those institutions which offer both depositary and fund administration services are less willing to accept a depositary appointment unless they are also appointed for fund administration and can leverage their current systems, processes and resources. Theoretically, a dual appointment should result in operational efficiency, avoid duplication of functions and also lead to lower costs for the AIF. Managers wishing to maintain a separate fund administrator and depositary should expect the depositary to be less comfortable with data generated by unaffiliated fund administrators, necessitating the development of systems and processes to recreate such data.

5. Depositary Liability Costs – There has been a lot of commentary about the anticipated changes to charges that depositaries will seek to levy to recover the costs of addressing their new responsibilities, including the liability being transferred to them. The transfer of liability may result in additional costs for depositaries; the investments being made in systems, processes and resources to mitigate new risks are also factors that will impact on pricing for depositary services.

PRIME BROKER PERSPECTIVES

Prime brokers and depositaries have been working together for some time, both bilaterally and through industry associations, to identify and address the challenges arising from the application of the AIFM Directive to existing prime brokerage service models. The emphasis has been on meeting the legislative objectives for investor protection while mitigating the impact on trading, financing and asset servicing arrangements, in so far as possible. While each institution will need to make its own assessments about the models it is capable of supporting and willing to apply, a number of areas of common concern have been identified through these discussions. In some cases, further clarity is required from regulators about the correct application of the new rules, while in others, the rules are still being written and issued. Some points can be resolved through flexibility around operational processes, but others do not have obvious technical solutions. What does appear clear is that prime brokers holding fund assets in custody will need to provide enhanced disclosure and reporting on their processes and sub-custody networks to multiple depositaries; each subcustodian potentially requiring information to be reported in a different format, which will be an additional resource burden for prime brokers.

1. Risk mitigation – Depositaries typically require that their custody delegates (i.e. their subcustodians) indemnify them against the loss of assets and certain other risks. It is expected that depositaries will seek indemnities from prime brokers when they are holding fund assets in custody. The provision of an indemnity by a prime broker may give rise to additional costs, and it remains to be seen how such costs are passed on to clients.

   Depositaries are expected to seek the right to move or direct the movement of assets from a subcustodian of a prime broker to a replacement, or to move assets from one prime broker to another, should they determine it is required in the interests of asset safety. However, it is unclear at this stage how such rights would work practically - particularly when assets need to be retained by the prime broker to secure obligations owed to it by a fund. One thing is clear: any weakening of the prime broker's rights of recourse to assets held in a prime brokerage account will increase the risk profile of the AIF from the perspective of the prime broker, which could impact on pricing and margin terms.

Depositaries are also expected to seek contractual rights to require a manager to move its business from one prime broker to another; for example, if they have credit concerns which cannot be resolved. There are multiple issues with this, including: whether another prime broker will be willing or able to take on the portfolio at the time the depositary has instructed the transfer; whether the fees will be over normal market rates, given the circumstances of the transfer; the impact on the market; and the potential consequences of a depositary effectively stating that it believes a prime broker is in financial difficulty (with attendant contagion risk), if the assessment is made prematurely. The criteria for making such a determination will be specific to each depositary, so it will be difficult to predict when such a request might be made or what involvement managers will have at the time.

2. Depositaries and affiliated prime brokers – Prime brokerage businesses which have affiliated depositaries have certain advantages in relation to risk management, owing to the common high standards applied by both. For example, they typically share a common subcustody network or, at the very least, benefit from consistent approaches to network management. This means that for the portion of the portfolio held with the affiliated prime broker, there is more likely to be a standardization of approach, including information and risk management techniques, between the depositary and prime broker. This could yield efficiencies which may not be available to non-affiliated prime brokers and depositaries.

3. Liability discharge – The AIFMD provides a limited ability for the depositary to transfer both the custodial function and legal liability for the restitution of custody assets to a delegate, provided that: there is an “objective reason” for doing so; the fund manager agrees that it is in the interests of investors; and investors have notice of the arrangement. To date, regulators have been unwilling to approve specific models or arrangements, with the result that there is legal and practical uncertainty about the ability of depositaries to effect this transfer to prime brokers.

WHATS NEXT?

The challenge for fund managers is that the new depositary liability regime is driving changes to industry practices that have not yet reached their final state. Managers crave certainty and need to know what depositary solutions will cost in terms of their specific portfolio, the terms of any legal documentation, and whether they will need to adapt current operational procedures. Managers are keen to explore approaches or solutions which enable the current operating model to continue; for example, they are keen to understand whether the discharge of liability is a workable solution, if it is practicable and cost-effective. Managers should evaluate their current arrangements and conduct cost-benefit analyses to determine whether, and if so, what changes they should be making. The analyses should also weigh up the pros and cons of using a separate depositary and administrator, versus an affiliated depositary and administrator arrangement, given the synergies expected to come from combined offerings. In addition, strategies where cash securities settle in frontier markets should be evaluated to determine the cost implication arising from depositary liability and whether depositaries are willing to accept an appointment in respect of these strategies .

In the interests of understanding further the different perspectives and often competing principles of depositary liability issues and being ready for questions from investors, we suggest the time is right for managers to step up their engagement both on a bilateral basis and importantly through a collective forum such as a trade association to ensure their views can contribute to the shaping of the model that will affect them for years to come.

If you would like to discuss any aspect of this client briefing further, please contact us.
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