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**FINANCIAL MARKETS LAW COMMITTEE**

**ISSUE 145: ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE**

*The implementation of the Alternative Investment Fund Managers Directive:  
discussion of legal uncertainties arising from the FSA's proposals for  
the transitional period and depositaries*



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# 1 INTRODUCTION AND EXECUTIVE SUMMARY

## Introduction

- 1.1 The role of the Financial Markets Law Committee (the “FMLC”) is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the financial markets which might give rise to material risks and to consider how such issues should be addressed.
- 1.2 The Financial Services Authority (the “FSA”) published the first of two consultation papers on the implementation of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (“AIFMD”) in November 2012 (the “Consultation Paper”).<sup>2</sup> This paper addresses areas of legal uncertainty arising from the proposals in the Consultation Paper. These legal uncertainties fall into two categories: (i) transitional issues, and (ii) issues relating to depositaries.
- 1.3 The body of this paper examines proposals concerning the authorisation of managers, the treatment of depositaries and the regulation of marketing during the transitional period. The Appendix outlines points of uncertainty relating to the regulation of depositaries under the new regime and provides suggestions for their clarification.
- 1.4 The FMLC acknowledges that the European Commission published a delegated regulation on 19 December 2012 setting out implementing measures with regard to depositaries and other matters (the “Level 2 Regulation”)<sup>3</sup> and that HM Treasury launched its consultation on transposing the AIFMD into UK law on 11 January 2013,<sup>4</sup> both during the consultation period for the Consultation Paper. HM Treasury launched a further consultation on transposing the AIFMD into UK law on 13 March 2013.<sup>5</sup> This paper seeks to address only those areas of legal uncertainty which are within the FSA’s gift to clarify.

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<sup>2</sup> “Implementation of the Alternative Investment Fund Managers Directive, Part 1”, CP12/32.

<sup>3</sup> “Commission delegated regulation (EU) No .../.. of 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision”.

<sup>4</sup> “Transposition of the Alternative Investment Fund Managers Directive”.

<sup>5</sup> “Transposition of the Alternative Investment Fund Managers Directive: further consultation”.

## **Executive summary**

- 1.5 The FMLC considers that the Consultation Paper does not make sufficient provision as to the position of managers and funds during the transitional period. In particular, there is uncertainty as to the authorisation and variation of permission of managers during the transitional period, as discussed in Section 2. Greater clarity is required as to whether an existing manager can market funds in the UK or launch new funds during the transitional period. Furthermore, there is uncertainty as to the position of depositaries in the transitional period. In Section 3, the FMLC recommends that the FSA provide further guidance on the liability of depositaries, the circumstances in which they can be appointed and their scope for accepting new clients during the transitional period. Finally, in Section 4, the need for greater clarity as to marketing during the transitional period, in particular regarding the operation of private placement regimes, is raised and considered.
- 1.6 The FMLC concludes that it would be helpful if the FSA could provide guidance to clarify how certain provisions of the AIFMD and the Level 2 Regulation which relate to the regulation of depositaries will be applied in the UK (as set out in the Appendix).

## **2 AUTHORISATION OF MANAGERS IN THE TRANSITIONAL PERIOD**

- 2.1 The implementation date of the AIFMD is 22 July 2013. According to the Consultation Paper, the Financial Conduct Authority (the “FCA”) does not expect to start accepting applications for authorisation from fund managers (prospectively “AIFMs”) before 23 July 2013, the day after the implementation date. Where an applicant for authorisation provides all the relevant information, an application will be determined within three months (the period specified in the AIFMD). This three-month period will be extended by another three months in certain circumstances (and only when the applicant has been notified of the extension, in line with the requirement to do so under the AIFMD).<sup>6</sup>
- 2.2 Under the AIFMD, firms which manage or market qualifying funds (“AIFs”) as at 21 July 2013 benefit from a one year transitional period and are not required to

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<sup>6</sup> Paragraph 4.13 of the Consultation Paper.

apply for authorisation and comply with the AIFMD until 21 July 2014. Instead, as acknowledged in the Consultation Paper, the draft regulations published by HM Treasury (the “Draft Regulations”) propose that a firm managing an AIF before 22 July 2013

will be permitted to continue its collective portfolio management activities, subject to the Handbook rules applying immediately before that date.<sup>7</sup>

The FMLC notes that this statement may be subject to change or clarification following the consultation period, and that the FSA or HM Treasury may determine that certain aspects of the AIFMD, such as reporting obligations, will apply prior to 21 July 2014, particularly although not exclusively in the case of third country AIFMs (as discussed further at paragraph 4.6, below). The FMLC would therefore welcome clarification from the FSA as to whether AIFMs will need to comply with any additional obligations (in accordance with the AIFMD) during the transitional period, which are outside the Handbook rules applying immediately before 22 July 2013.

2.3 It is also unclear whether the exemption for existing AIFMs (which manage an AIF before 22 July 2013) from being authorised or registered during the transitional period will apply where such AIFMs launch new funds. Under one interpretation of the Draft Regulations, this exemption will apply irrespective of whether existing AIFMs launch new funds in that period on the basis that

- a. Draft Regulation 68(1), applies where a UK AIFM “carries on the activity of managing an AIF immediately before 22nd July 2013”, but does not refer to particular funds managed by the AIFM;
- b. Draft Regulation 68(3) states that the requirements for marketing AIFs (set out in Part 8 of the Draft Regulations) do not apply in respect of an AIF managed by an AIFM falling within Draft Regulation 68(1);
- c. Draft Regulation 68(3) does not specify that such an AIF needs to be managed before 22 July 2013; and

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<sup>7</sup> Paragraph 2.40 of the Consultation Paper.

- d. arguably, the exception in Draft Regulation 68(3) would therefore also apply in the case on an AIF managed by an AIFM which managed another AIF immediately before 22 July 2013.
- 2.4 There is uncertainty as to whether this is a correct interpretation of the Draft Regulations, and whether the ability to launch new products extends to stand-alone funds (i.e. a new legal entity), sub-funds of an existing umbrella and/or new share classes of an existing or newly-launched fund or sub-fund. The FMLC would therefore welcome confirmation from the FSA as to whether existing managers can launch new products in the UK during this period, prior to registration, in order to prevent AIFMs from being discouraged from pursuing legitimate activities owing to uncertainty as to whether this would comply with the regime.
- 2.5 Under draft FUND 3.10.2R, an AIFM must ensure the following, amongst other things, before a delegate carries out any function on its behalf: (i) that the FCA is notified of the delegation before the delegation arrangements become effective, and (ii) that it can justify the delegation structure with objective reasons. There is uncertainty as to whether entry into a contractual relationship to effect delegation is required before such notification can be made. In particular, UK AIFMs would be better placed to give notification of delegation arrangements at the appropriate time if the FSA specified whether it will require UK AIFMs to put in place a fully agreed contractual arrangement with delegates at the time the application for authorisation is made, or whether it will be acceptable for contractual negotiations to continue in parallel to an application for FSA authorisation.
- 2.6 The FMLC would therefore welcome clarification from the FSA as to:
- a. the circumstances in which the FSA will extend the three month period for determining an application for authorisation during the transitional period;
  - b. whether it considers that the transitional provisions allow an existing manager to market funds in the UK or launch new products during this transitional period without registering under the AIFMD; and
  - c. whether the FSA will require a fully agreed contractual arrangement with

delegates to be in place at the time the application for authorisation is made, or whether it will be acceptable for contractual negotiations to continue in parallel to an application for FSA authorisation.

### **3 DEPOSITARIES IN THE TRANSITIONAL PERIOD**

3.1 In the text accompanying the Draft Regulations, HMT Treasury notes that there will be a new regulated activity of acting as trustee or depositary of an AIF under proposed paragraph 51ZD FSMA 2000. Although (as set out at paragraph 2.2 above), AIFMs have until 21 July 2014 to submit an application for authorisation and comply with the AIFMD, Article 61 of the AIFMD does not provide transitional arrangements for depositaries.

3.2 An AIFM, in order to comply with the AIFMD, does not therefore need to ensure that its AIF appoints a depositary until 21 July 2014 (or the date when the AIFM receives its variation of permission or authorisation as the case may be). The FMLC considers, however, that clarification is required as to:

- a. the obligations of a depositary during the one year transitional period;
- b. whether an AIFM which is utilising some, or all, of the transitional period is permitted to arrange for the appointment by the AIF of a new depositary during that twelve-month period; and
- c. whether a depositary is allowed to accept an appointment by an AIF which is managed by an AIFM which has not yet been granted FCA authorisation or a variation of a Part IV FSMA permission (“Variation of Permission”) during the transitional period (an “Unregistered AIFM”).

3.3 One particular area which requires clarification is in respect of the liability provisions of depositaries during the transitional period. It is unclear how a loss of assets subject to a claim under the AIFMD which arises between 22 July 2013 and 21 July 2014 will be treated if a depositary is acting for an AIF managed by an Unregistered AIFM, and which, consequently, is not yet compliant with the AIFMD. Some trustees and depositaries (for example, trustees and depositaries of Non-UCITS Retail Schemes) will already have been appointed and will be

conducting levels of supervision similar to those required under the AIFMD. However, where a depositary is acting for an AIF managed by an Unregistered AIFM, which is utilising the transitional period, there is uncertainty as to whether the depositary will have assumed liabilities by default even where there has not been a formal appointment by the AIFM. If there is a loss of assets in custody during this period, it is possible that AIF investors will seek to make a claim against the trustee or depositary (even if the trustee or depositary has not yet been appointed to its role pursuant to Article 21 of the AIFMD). It would be helpful to have some clarification of the obligations to which, from July 2013, depositaries are subject prior to acting for an AIF managed by an AIFM which has been granted FCA authorisation or a Variation of Permission (in this case, a “Registered AIFM”) or, alternatively, until 21 July 2014 (being the last date by which formal appointment is required).

- 3.4 Such clarification might provide that a depositary is not obliged to act as a depositary pursuant to Article 21 of the AIFMD until the AIF itself is managed by a Registered AIFM (or by 21 July 2014 at the latest). Alternatively, the clarification might provide that a depositary cannot act as depositary for an AIF until that AIF is managed by a Registered AIFM.

#### **4 MARKETING IN THE TRANSITIONAL PERIOD**

- 4.1 There is uncertainty as to what it means for the FSA to keep the private placement regime open under Articles 36 and 42 of the AIFMD. It is not clear whether, during the transitional period, an Unregistered AIFM based in the UK will be permitted to market an AIF pursuant to the existing private placement regimes (where applicable), or whether only “reverse solicitation” of an AIF will be possible.
- 4.2 As set out at paragraph 2.1 above and as indicated at paragraph 4.13 of the Consultation Paper, the FCA does not expect to start accepting applications for authorisation from prospective AIFMs before 23 July 2013. This approach may place UK AIFMs at a disadvantage to both EU AIFMs based outside the UK, who are able to take advantage of the AIFM marketing passport, and non-EU AIFMs using the private placement regime to market their AIFs. UK AIFMs managing EU AIFs will be unable to avail themselves of the AIFMD marketing passport for a

period of up to six months following 22 July 2013, while non-EU AIFMs can market AIFs in accordance with the private placement regimes applicable in the relevant Member States.<sup>8</sup> In contrast, EU AIFMs based outside the UK, who have the ability to submit an application for authorisation or Variation of Permission to their home state regulators prior to 23 July 2013 (as in Ireland, for instance), will be able to apply to market AIFs that they manage from 23 July 2013 and be able to do so under the marketing passport 20 days later. It remains unclear whether UK AIFMs managing EU AIFs, or UK AIFMs managing non-EU AIFs, will be able to rely upon the national private placement regimes in the transitional period. In the event that UK AIFMs cannot be authorised pursuant to the AIFMD with effect from 22 July 2013, there is a risk of inconsistent application of the AIFMD by Member States to the marketing activities of AIFMs.

4.3 As an example of an approach taken in another Member State, this uncertainty has been clarified in respect of the new German regime for AIFMs by Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), the German federal financial supervisory authority. BaFin will allow the private placement of a non-registered AIF to continue under the existing regime until 21 July 2014 (throughout the one year transitional period), provided the AIFM holds a MiFID passport. After 21 July 2014, marketing of AIFs will only be permitted if the AIFM is either (i) registered under the new German regime for AIFMs, or (ii) the AIFM (in respect of EU AIFs) elects to exercise its AIFMD passporting rights. If, however, the investment strategy of the AIF is adapted to the AIFMD requirements during the transitional period, the rules of the AIFMD have to be addressed. As a consequence of this, if an AIFM wishes to continue to manage a fund in Germany during the transitional period, the AIF cannot be changed in any way during the period until 22 July 2014.

4.4 The treatment of foreign funds under the German regime, as set out at paragraph 4.3, is, in part, a response<sup>8</sup> to the transitional provisions which will apply to German AIFs. Article 61(1) of the AIFMD provides for a transitional phase of one year during which an application for a revised authorisation should be filed. As well as the application for authorisation, certain other relevant documents are required to be

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<sup>8</sup> Article 42 of the AIFMD

adapted to the new rules, including the strategy and the constitutional documents. Given that this application process takes time, Bundestag, the German legislator has chosen to make use of the complete one year transitional period.

- 4.5 It is helpful that HM Treasury has confirmed that the UK private placement regime will continue for third country AIFMs wishing to market into the UK subject to complying with transparency requirements under the AIFMD.<sup>9</sup> The FMLC also notes that the FSA confirmed, when it launched a survey for UK AIFMs in March 2013, that it is exploring options to support firms in their preparations for the AIFMD, including accepting applications for authorisation before 22 July 2013. However, there is some uncertainty regarding how the marketing of a UK AIF to professional investors in the EU between 21 July 2013 and 21 July 2014 will be regulated. Other Member States could decide to close or restrict their private placement regimes and permit marketing only through a new EU marketing passport from July 2013. UK AIFMs will not be able to avail themselves of this passport until such time as their FCA authorisation or a Variation of Permission has been granted and the FCA has notified the host Member State of the AIFM's intention to manage UK AIFs on a cross-border basis. This could take several months during which the UK AIFM would be unable to market AIFs on a cross-border basis. The FMLC would welcome clarification from the FSA as to whether any provision will be made to enable a UK AIFM to market EU AIFs in other Member States pending authorisation as a Registered AIFM, or whether the FSA will permit UK AIFMs to apply for authorisation or a Variation of Permission before the July implementation date if the private placement regimes in other Member States are in fact widely disappplied during the transitional period.
- 4.6 The implementation of the AIFMD in other Member States is also relevant to the issue as to whether an AIFM that carries out 'MiFID services' under Article 6(4) has the right under the AIFMD to passport those services to other Member States. The Consultation Paper provides that

a UK firm will hold the same Part IV permissions, whichever Directive they are considered to derive from, so UK AIFMs are likely to be able to provide

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<sup>9</sup> Paragraph 6.3 of the Consultation Paper; Article 42 AIFMD; paragraph 3.8 of the text accompanying the Draft Regulations.

those services elsewhere in the EEA.<sup>10</sup>

The Consultation Paper acknowledges the risk that other Member States may take a different view, and refuse to permit AIFMs to passport those derogated services without a MiFID licence limited to those specified activities. This could cause uncertainty and inhibit operational planning, in the case of UK AIFMs which seek to passport their individual portfolio management activities (for segregated mandates) into the EEA where that the relevant Member States may reject the passport on the basis that the UK entity is an AIFM. The FMLC would welcome clarification from the FSA as to whether regulators in other Member States have indicated whether they will accept the FSA's approach and permit UK AIFMs to provide MiFID services under an EU marketing passport where they hold a Part IV permission.

- 4.7 It appears to the FMLC that third country AIFMs will not benefit from the transitional provisions (which allow UK AIFMs 12 months to apply for authorisation), on the basis that:
- a. third country AIFMs are not required to apply for authorisation or a Variation of Permission;<sup>11</sup>
  - b. the transitional provision set out at Draft Regulation 68 only applies to UK AIFMs; and
  - c. Draft Regulations 51 and 60 provide that in order for third country AIFMs to market AIFs in the UK (i) such third country AIFMs will need to obtain the approval from the FCA for marketing the AIF in accordance with Draft Regulation 60, and (ii) the AIF's entry on the Article 42 register must not have been suspended or revoked.

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<sup>10</sup> Paragraph 4.18 of the Consultation Paper.

<sup>11</sup> Article 42 AIFMD; paragraph 2.40 of the Consultation Paper.

The FMLC considers that operational planning would be facilitated if the FSA indicated whether this interpretation is correct (that is, that the transitional provisions will not apply to third country AIFMs, and that third country AIFMs will be subject to reporting and transparency requirements from 22 July 2013).

## **5 CONCLUSION**

- 5.1 These areas of legal uncertainty risk limiting the ability of market participants to prepare for, and operate their businesses throughout, the transitional period. The FMLC considers that greater clarity is required from the FSA in order to facilitate the effective operation of AIFMs, depositaries and cross-border marketing during this period.
- 5.2 The FMLC would welcome guidance from the FSA, or the circulation of draft transitional provisions of FUND, on these areas of uncertainty in advance of the implementation date. In particular, it recommends that the FSA clarify:
  - a. the circumstances in which the FSA will extend the three month period for determining an application for authorisation;
  - b. whether an Unregistered AIFM can market funds in the UK or launch new products during the transitional period;
  - c. the circumstances in which depositaries can be appointed, or can accept an appointment by an AIF which is managed by an Unregistered AIFM during the transitional period, and the extent of their liability prior the AIFM becoming a Registered AIFM; and
  - d. how the private placement regime will operate in the UK, and whether any provision will be made to facilitate cross-border marketing if private placement regimes are closed or restricted in other Member States.

## APPENDIX

### 1 DEPOSITARIES

1.1 The FSA rules reflecting the AIFMD in the draft FUND sourcebook replicate a number of the provisions of the AIFMD. As the AIFMD was drafted as an EU Directive, but the FSA rules take effect as regulatory requirements under the UK regulatory regime, the FMLC considers that there is uncertainty as to whether the AIFMD can be used to interpret such FUND rules and whether the FUND rules can be considered as definitive in this respect. The Consultation Paper explains that the FSA does not intend to incorporate all of the Level 2 Regulations into its Handbook, and refers to various existing provisions of the FSA Handbook (such as the FSA Remuneration Code (SYSC 19A)).<sup>12</sup> The Level 2 Regulations contain a degree of detail, when overlaid on the AIFMD as implemented by the FUND rules, which would likely provide more certainty for market participants if reflected comprehensively in the FUND rules. In addition, there may be uncertainty as to how the Level 2 Regulations interact with existing provisions in the FSA Handbook, or whether they should be viewed as stand-alone provisions. One possible solution to this would be for the FSA to provide guidance specifying (i) whether market participants should refer to the AIFMD when interpreting these provisions, and (ii) whether the Level 2 Regulations should be interpreted in the context of other provisions in the FSA Handbook, even where no reference is made to the relevant provisions of the Level 2 Regulations in the FSA Handbook.

#### **Functional and hierarchical separation**

1.2 Article 21(4) of the AIFMD, which is implemented in draft FUND 3.11.6R, provides that

In order to avoid conflicts of interest between the depositary, the AIFM and/or the AIF and/or its investors [...] a prime broker acting as counterparty to an AIF shall not act as depositary for that AIF, 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 to the investors of

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<sup>12</sup> Paragraphs 1.10 and 7.64 of the Consultation Paper.

the AIF.

- 1.3 Similarly, Article 21(10) of the AIFMD, which is implemented in draft FUND 3.11.8R, provides that

A depositary shall not carry out activities with regard to the AIF or the AIFM on behalf of the AIF that may create conflicts of interest between the AIF, the investors in the AIF, the AIFM and itself, unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF.

- 1.4 There is uncertainty as to what steps need be taken to achieve “functional and hierarchical separation” of depositary and prime broker functions, and of the depositary function and potentially conflicting tasks. This uncertainty could be mitigated if the FSA issues guidance on how it will interpret these provisions.

- 1.5 In particular, the FMLC would welcome guidance from the FSA as to whether the requirements in Article 42 of the Level 2 Regulations regarding “functional and hierarchical separation” of the risk management function are applicable by analogy. Article 42 of the Level 2 Regulations sets out the following conditions to be satisfied in order that the risk management function shall be considered as functionally and hierarchically separated from the operating units

- (a) persons engaged in the performance of the risk management function are not supervised by those responsible for the performance of the operating units, including the portfolio management function, of the AIFM;
- (b) persons engaged in the performance of the risk management function are not engaged in the performance of activities within the operating units, including the portfolio management function;
- (c) persons engaged in the performance of the risk management function are compensated in accordance with the achievement of the objectives linked to that function, independently of the performance

of the operating units, including the portfolio management function;

- (d) the remuneration of senior officers in the risk management function is directly overseen by the remuneration committee, where such a committee has been established.

### **Delegation to third parties**

1.6 Article 21(11)(b) of the AIFMD, provides that

The depositary may delegate to third parties the functions referred to in paragraph 8 subject to the following conditions: [...]

- (b) the depositary can demonstrate that there is an objective reason for the delegation.

1.7 Article 21(11)(b) has not been replicated in the FUND rules, and the FMLC would welcome an indication from the FSA as to whether it will be transposed into UK law. There is uncertainty as to the criteria which will be taken into account when assessing whether there is an “objective reason” for delegation. Article 76 of the Level 2 Regulation sets out the following criteria which will be considered within the meaning of Article 20(1)(a) of the AIFMD

- (a) optimising of business functions and processes;
- (b) cost saving;
- (c) expertise of the delegate in administration or in specific markets or investments;
- (d) access of the delegate to global trading capabilities.

### **Segregation of assets**

1.8 Article 21(11)(d)(iii) of the AIFMD, which is implemented in draft FUND 3.11.25(4)(c) R, provides that the depositary may delegate certain functions to third parties, provided that the depositary ensures that

the third party 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

depository.

- 1.9 It is not clear from the Consultation Paper whether the FSA considers that this requirement will be met if the third party maintains separate records in its books. The FMLC considers that depositories would benefit from guidance from the FSA which indicates whether this is an appropriate interpretation.

**Application of rules “mutatis mutandis”**

- 1.10 The AIFMD and the Level 2 Regulation provide that certain rules will apply “mutatis mutandis” to the relevant parties. In particular:

- a. Article 21(11) of the AIFMD, which is implemented in draft FUND 3.11.27R, provides that

The third party may, in turn, sub-delegate those functions, subject to the same requirements. In such a case, paragraph 13 shall apply *mutatis mutandis* to the relevant parties.

- b. Article 98 of the Level 2 Regulation provides that

Where the third party further delegates any of the functions delegated to it, the conditions and criteria set out in paragraphs 1, 2 and 3 shall apply *mutatis mutandis*.

- c. Article 99(3) of the Level 2 Regulation provides that

Paragraphs 1, and 2 shall apply *mutatis mutandis* when the third party, to whom safekeeping functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU, has decided to delegate all or part of its safe-keeping functions to another third party pursuant to the third subparagraph of Article 21(11) of Directive 2011/61/EU.

- d. Article 104(4) of the Level 2 Regulation provides that

This Article shall apply *mutatis mutandis* to the delegate when the depository has contractually transferred its liability in accordance with Article 21(13) and (14) of Directive 2011/61/EU.

- 1.11 There is uncertainty as to how these requirements will apply to the delegate and sub-delegate, for instance, whether this means that the relevant requirements are to be applied to the delegate and sub-delegate as if the delegate were in the position of the depositary, and the sub-delegate was in the position of the delegate.
- 1.12 The rules which apply “mutatis mutandis” apply directly to delegates in the EU as a result of Level 2. It is not clear how these obligations will apply where the delegate is not in the EU, for instance, whether a depositary would be required to impose contractual obligations in the same form.
- 1.13 The FMLC therefore recommends that the FSA specifies how these requirements will apply to sub-delegates, and to delegates who are not operating in the EU.

### **Securities settlement systems**

- 1.14 The final paragraph of Article 21(11) of the AIFMD provides that

For the purposes of this paragraph, the provision of services as specified by Directive 98/26/EC by securities settlement systems as designated for the purposes of that Directive or the provision of similar services by third-country securities settlement systems shall not be considered a delegation of its custody functions.

- 1.15 The FMLC would welcome clarification from the FSA regarding whether it considers that central counterparties fall within the category of securities settlement systems (for instance, because such entities are similar market infrastructures which may hold assets for AIF depositaries) or whether they may be treated as delegates of AIF depositaries.

### **Written contracts**

- 1.16 Article 21(13)(b) of the AIFMD provides that

Notwithstanding the first subparagraph of this paragraph, in case of a loss of financial instruments held in custody by a third party pursuant to paragraph 11, the depositary may discharge itself of liability if it can prove that [...]

[...] a written contract between the depositary and the third party expressly transfers the liability of the depositary to that third party and makes it

possible for the AIF or the AIFM acting on behalf of the AIF to make a claim against the third party in respect of the loss of financial instruments or for the depositary to make such a claim on their behalf.

- 1.17 It is unclear whether a written contract must make explicit provision for the AIF (or the AIFM acting on behalf of the AIF) to make such a claim against a third party. The FMLC recommends that the FSA provide guidance as to whether the rights of the AIF (or AIFM) under the Contracts (Rights of Third Parties) Act 1999 are sufficient, or whether the depositary would be required to agree by way of contract with the AIF (or AIFM) that it will pass its rights against the delegate by subrogation.

### **Process for reconciliation**

- 1.18 Article 86 of the Level 2 Regulation includes requirements for the depositary to monitor the AIF's cash flows, including the requirement to

implement effective and proper procedures to reconcile all cash flow movements and perform such reconciliations on a daily basis or, in case of infrequent cash movements, when such cash flow movements occur.

- 1.19 It is unclear whether the depositary would be able to satisfy this reconciliation obligation by exercising oversight of the reconciliations carried out by AIFMs or whether it would be required to repeat such reconciliation process.

- 1.20 Similarly, Article 89(1)(c) requires that a depositary ensure that

reconciliations are conducted on a regular basis between the depositary's internal accounts and records and those of any third party to whom custody functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU.

- 1.21 It is unclear whether this reconciliation obligation applies to both the depositary and the delegate. This uncertainty could be resolved by guidance from the FSA on what which parties will be subject to these reconciliation obligations, and whether they can be satisfied by oversight of the other party's reconciliation process.

## **Assets held in custody**

1.22 Article 88(2) of the Level 2 Regulation provides that

Financial instruments which, in accordance with applicable national law, are only directly registered in the name of the AIF with the issuer itself or its agent, such as a registrar or a transfer agent, shall not be held in custody.

1.23 It is unclear what obligations a depositary would have in relation to securities registered in the record of title in the name of the AIF, and whether these obligations would be affected by the registration requirements applicable under local law. This could be clarified if the FSA provided guidance specifying that the depositary does not hold assets in custody (and has no obligations relating to holding assets in custody) where securities are registered in the record of title in the name of the AIF, regardless of whether local law only permits registration in the name of the AIF.

1.24 Article 89(2) of the Level 2 Regulation provides that

Where a depositary has delegated its custody functions to a third party in accordance with Article 21(11) of Directive 2011/61/EU, it shall remain subject to the requirements of points (b) to (e) of paragraph 1 of this Article. It shall also ensure that the third party complies with the requirements of points (b) to (g) of paragraph 1 of this Article and the segregation obligations laid down in Article 99.

1.25 Article 89(2) does not confirm whether or not a depositary is also subject to the requirement in Article 89(1)(a) (to ensure that the financial instruments are properly registered in accordance with Article 21(8)(a)(ii)). The reference to “points (b) to (e) of paragraph 1” only, suggests that Article 89(1)(a) will not apply in this case. The FMLC would welcome guidance from the FSA regarding whether a depositary would be required to ensure proper registration of financial instruments in these circumstances.

1.26 Articles 89(3) and 90(5) of the Level 2 Regulation provide that a depositary’s safe-keeping duties

shall apply on a look-through basis to underlying assets held by financial

and, as the case may be, or legal structures controlled directly or indirectly by the AIF or the AIFM acting on behalf of the AIF.

- 1.27 It is unclear whether the look-through mechanism applies only to these provisions, or is intended to apply other provisions of the AIFMD or the Level 2 Regulation, which apply to depositaries. The FMLC recommends that the FSA provide guidance as to when the look-through mechanism shall apply.

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<sup>13</sup> Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.