THE LONG VIEW

PETER ASTLEFORD AND CONOR DURKIN
are debating the growing power of depositaries, post-AIFMD

"DEPOSITARIES WILL HAVE THE ABILITY TO ALTER THE CHANCES OF THE APPOINTMENT OF A PARTICULAR ADMINISTRATOR OR PRIME BROKER – A NEW SHIFT IN THE BALANCE OF POWER"

The role envisaged under the Alternative Investment Fund Managers Directive (AIFMD) for depositaries, will alter the landscape of the hedge fund industry in Europe.

Under AIFMD a depositary will be generally required. No other third party (except auditors) will have this privileged position. The depositary will often be required to replace assets that are "lost" from safekeeping and carry out detailed monitoring and reconciliations of a fund's cash flows, effectively acting as the policeman of part of the administrator's functions. The new liability regime will result in an increase in fees.

The rate cards custodians currently use for pricing custodial fees in different markets are likely to be replaced with a matrix pricing structure. Fees will take into account a myriad of factors, including: the types of assets the fund will hold; the use of a prime broker; and the relationship between the administrator and the depositary.

For depositaries that provide safekeeping in emerging markets, the risk of loss to a fund's asset will be most acute and depositaries are therefore expected to charge a risk premium for this business (or not provide cover). Concerns over depositary liability may restrict the choice of depositary where only the larger depositaries with extensive in-house sub-custody networks and capital are prepared to operate.

The indications are that hedge funds will request their depositary to appoint the prime broker as sub-custodian, thus preserving funds' reliance on prime brokers for settlement and custody. Depositaries take the view that prime brokers pose a level of risk which will lead to an increase in the depositaries' cost. The risk premium to be charged by depositaries is based on lack of familiarity with, and in some cases concerns over, the level of oversight by prime brokers of their sub-custody network. Depositaries also point to the costs required to develop the infrastructure required to monitor and reconcile the prime broker's records.

The depositaries' influence over prime brokers will increase as depositaries will require detailed reporting from prime brokers and also for prime brokers to be appointed sub-custodian over assets that are held which are not re-hypothecated. The need to develop a suitable operating model may lead to the partnering of certain depositaries and prime brokers, altering the choice available in the marketplace.

Alternatives to full depositary liability are being considered and the so-called "depositary light" regime will be a solution for some managers. Under AIFMD a manager may, subject to national private placement rules, sell a non-EU fund in the EU, provided that one or more entities (who are not subject to the liability regime, thus "depositary light") are appointed to carry out depositary oversight functions. Depositary light should work for distribution in the UK (where the financial promotions regime is expected to continue); however, it will be of limited benefit for distribution in member states like Germany or France where national laws will prohibit marketing without a passport.

The relationship between administrators and depositaries may be redefined as both entities seek to employ additional resources to comply with enhanced reporting requirements. For third party administrators, their ability to sign on new clients may be hampered by the unwillingness of depositaries to work with them either because of risk perception, the costs of developing new reporting processes or to favour the depositaries' in-house administrator.

As we come to the final stages of the implementation of the AIFMD, it is clear that depositaries will have the ability to alter the chances of the appointment of a particular administrator or prime broker – a new shift in the balance of power. ■

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