Depositary-lite and the challenge of implementation

Under the requirements of the AIFMD, UK and other EU hedge fund managers that wish to market their non-EU, offshore hedge funds to EU investors through private placement, will need to comply with the "depositary-lite" regime.

The depositary-lite regime requires **one or more firms** to be appointed to perform a number of trustee-like duties on the fund. These include the safe keeping of assets, cash flow monitoring and oversight of the fund (principally the oversight of the valuation process, subscriptions and redemptions, compliance with laws and regulations, investment restrictions and leverage).

These depositary-lite duties are essentially the same as for the full depositary regime. The key difference is that the new AIFMD strict liability for depositaries does not apply to the depositary-lite model.

It is interesting that even though AIFMD's depositary-lite requirements impact a far larger number of funds, they have received much less coverage in the industry than those managers subjected to the full depositary model. This is likely to change in the year ahead.

On-going challenges of implementation

Implementing the depositary-lite model is representing a number of challenges for the typical London AIFM managing a number of Cayman domiciled hedge funds.

The practical implementation of depositary-lite is slowly being put in place across the industry. EU AIFM's would be well advised not to under estimate the work involved in implementing a depositary-lite model for their non-EU funds. At this stage most AIFM's should be well embarked on the implementation process.

Many managers have complained that depositaries have been slow in responding to requests for depositary-lite pricing quotations. Depositaries themselves have been swamped with requests for pricing proposals and they appear to be focusing on providing those to the larger market players first.

Where pricing proposals have been received, some AIFMs have been surprised at the relatively small cost differential between quotations for the full depositary and depositary-lite models (potentially as small as 1 basis point). This is because the day to day service the depositary will provide managers is basically the same – regardless of the depositary model.

Depositaries are currently expanding and training their teams, while also interpreting the practical implementation of the AIFMD rules. Not all of these rules are clear yet. Depositaries are setting up data and reporting linkages with administrators and this will be a challenge where the fund's administration is performed by a different company, particularly for large complex hedge funds using multiple administrators.

For depositary-lite it is up to the AIFM to ensure that the depositary gets the access they need to the administrator's shareholder records, NAV process and cash reporting. AIFM's will need to work with their service providers and prime brokers to put these relationships in place and ensure they are implemented successfully.

The regulatory view

Most European regulators have been silent on how they will govern and enforce the depositary-lite regime. None of the key fund regulators in the UK, Ireland or Luxembourg have issued substantial opinion or commentary. In Ireland the Central Bank has recently clarified the rules around the authorisation required in offering this service, but we have yet to receive any guidance into the models implementation.

This would be particularly welcome in the case of **complex fund set-ups**, where there may be multiple providers of custody services (i.e. where multiple parties could be named as providing the depositary-lite service).

It would also be useful to understand the national regulators view around managing conflicts of interest, where the same large organisation could be providing depositary, custody and administration services to an AIFM.

Furthermore, the delay in some depositaries providing pricing quotations to managers has meant AIFMs are having to push back the submission of their application for authorisation with their national regulators.

The future of depositary-lite

Where will depositary-lite model end up?

In the short term, smaller independent administrators see the depositary-lite regime as an opportunity to provide **additional services** to clients while protecting their existing revenue, particularly as those without the deep pockets of a large bank behind them will be unable to offer the full depositary service.

The new depositary rules are also fostering the establishment of a number of independent depositaries, outside of the standard model of a large administrator with a global bank standing behind them. INDOS was recently approved by the FCA in the UK to provide depositary services to the market. We are likely to see other entities approved to provide these services over the next few months.

Currently some larger service providers are willing to look at providing depositary services in cases where they are not the administrator, possibly in the hope of winning the custody and administration business in later years.

After the likely end of the Private Placement regime in 2018, all funds managed or marketed into the European Union will need a full depositary. This means that the depositary-lite model may only be a temporary phenomenon. Many larger service providers recognise this and are putting in place internal operating models which will allow their depositary-lite clients to easily migrate to their full depositary service when the time comes.

As AIFMD gets bedded-down, the hedge fund industry appears to be moving to a **One-stop Shop** model, where administration, custody and depositary services are provided by one main service provider. While this could be an opportunity for larger administrators, it may have substantial negative implications for independent administrators and even accelerate the trend towards industry consolidation across the sector.

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