THE DEPOSITARY: AN INTEGRAL PART OF GUERNSEY'S RESPONSE TO THE AIFMD

LISA HAGGARTY AND **KEITH JOHNSON** OF **DEUTSCHE BANK** DISCUSS THE KEY ROLE DEPOSITARIES PLAY IN ADAPTING TO THE AIFMD

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joined Deutsche Bank in 2007 as head of Custody & Internet Delivery Solutions, focusing on developing our global custody offering and supporting our businesses in the Channel Islands and Cayman. He has more than 30 years of experience in all aspects of investment administration and global custody solutions.

In a move designed to provide investors with a greater degree of protection, the long awaited Alternative Investment Fund Managers Directive (AIFMD) Level 2 rules were issued on 19 December 2012.

As well as undoubtedly having wide-reaching implications for all non-Ucits open-ended funds which are actively marketed into the European Union (EU), or which have an EU-domiciled manager, the Directive will also impact closed-ended funds – although there will be exemptions in certain circumstances.

As a leading centre for alternative funds business, Guernsey has responded to the AIFMD by announcing its intention to offer a dual regulatory regime. This means that it will be business as usual for funds that do not fall under the scope of the AIFMD, as they will continue to be governed under existing regulations. On the other hand, the island will also be in a position to offer a fully-compliant solution for European funds.

Guernsey's flexible and innovative approach, combined with its wealth of knowledge and expertise and well established infrastructure and network of service providers, reinforces its intention to remain a world class jurisdiction for funds.

DEPOSITARY

One of the consequences of the AIFMD is that all funds that are within its scope will be required to appoint an eligible depositary, which is domiciled either in the jurisdiction of the fund or the manager, with effect from July 2013.

While this is nothing new for the majority of open-ended schemes, which are already required to appoint a local custodian under existing Guernsey regulation, it is likely to have a significant impact on closed-ended funds, including Guernsey's prominent private equity sector, which has not previously been subject to the enhanced levels of cost and compliance oversight that will result from having to appoint a depositary.

It is clear that the traditional roles and responsibilities of the custodian are set to change under the AIFMD, in order to achieve the objective of enhancing investor protection. One of the most significant considerations for the depositary will be its potential liability for the loss of financial assets, even in instances where the loss has not arisen through its own negligence. In order to escape liability, it will be necessary to prove that the loss was an external event that could not have been prevented, despite all reasonable efforts by the depositary.

This liability also extends to situations whereby the depositary has delegated safe keeping functions to a sub-custodian. In this case, it will be imperative for the depositary to evidence that it has carried out rigorous due diligence and ongoing oversight of any sub-custodian arrangements.

> "ONE OF THE MOST SIGNIFICANT CONSIDERATIONS FOR THE DEPOSITARY WILL BE ITS POTENTIAL LIABILITY FOR THE LOSS OF FINANCIAL ASSETS"

EXPERTISE AND RESOURCES

In practical terms, this means that the depositary must possess an adequate level of expertise and resources required to supervise any delegated activities and to manage the associated risks. This is likely to involve regular reviews of the procedures and internal controls of the sub-custodian to ensure that assets are subject to adequate care and protection throughout the custody chain at all times. Key considerations include, for instance, the verification of ownership rights and the segregation of assets.

Monitoring of cash flows is another activity that will require a greater degree of focus from the depositary, who will not only be required to have a clear overview of all of a fund's cash inflows and outflows, but will also be obliged to ensure that the fund has appropriate reconciliation procedures in place and that any discrepancies are remedied in a timely manner.

This additional layer of compliance oversight and the increased potential for financial liability of the depositary will undoubtedly result in higher custodian fees that will ultimately be borne by investors.

The expectation is that, when it comes to pricing business, there will be a greater focus on the type of assets to be held in custody. For example, some asset classes such

as hedge funds represent more risk to the depositary than other types, such as listed equities.

A further consideration for the depositary will be whether any assets are to be held with prime brokers. The existing Guernsey regulations allow for a derogation from the rules in certain circumstances, which enables the custodian to relinquish responsibility for assets that are held with prime brokers. This option will not be available for an AIFMD depositary, who will be forced to retain some degree of liability for these assets.

WELL PLACED

We firmly believe that Deutsche Bank in Guernsey is well placed to meet the challenges arising out of the AIFMD. The bank's global presence and its extensive, well established sub-custodian network will provide Deutsche Bank in Guernsey with the ideal framework to perform a depositary role within the context of Guernsey's innovative dual route approach to the AIFMD.

A further advantage is the fact that Deutsche Bank's philosophy has always been to work in partnership with clients to offer bespoke solutions to meet their needs, rather than providing a standard "one size fits all" service. This, combined with a pragmatic approach to custodian oversight, enables the level of flexibility needed to adapt to the changing regulatory environment and demands of clients.

Whilst the bank recognises the importance of developing its custodian offering to include an AIFMD-compliant depositary service, it also remains fully committed to continuing to work with hedge fund managers that want to keep an element of their strategy outside the Directive's scope.

> "DEUTSCHE BANK IN GUERNSEY IS ABLE TO OFFER A COMPREHENSIVE RANGE OF GLOBAL CUSTODY SOLUTIONS, BANKING FACILITIES, CURRENCY MANAGEMENT AND CREDIT FACILITIES"

It is this expertise, flexibility and innovative approach that has led to Deutsche Bank establishing itself as a leading custody provider in the Channel Islands – something that was underlined when it was named Custodian of the Year in the Channel Islands by Custody Risk in November 2012. In addition to its custodian trustee services, Deutsche Bank in Guernsey is also able to offer a comprehensive range of global custody solutions, banking facilities, currency management and credit facilities to meet its clients' needs.

The depositary function is a vital element of the new-look European funds landscape. With Deutsche Bank's strength, expertise and capabilities to offer this service in Guernsey, the jurisdiction can look forward to a bright future as a specialist centre for European – and global –fund business. ■