AIFMD – Collateral Arrangements for Depositaries

Directive 2011/61/EU on Alternative Fund Managers (AIFMD) includes a number of safeguarding requirements for assets of alternative investment funds (AIF) which mean that depositaries will be responsible for both assets of AIFs which are held on behalf of an AIF but also for assets which are provided by an AIF as collateral to other parties, such as prime brokers.

The use of collateral by prime brokers is traditionally seen as a key feature in the provision of financing to AIFs. The ability for a prime broker to take and use collateral leads to lower financing costs for an AIF.

The ability to use the collateral of an AIF presents challenges with respect to the duties on depositaries to safekeep such assets and not expose investors to loss. Any such losses may lead to potential liability for the depositary.

Safekeeping

Depositaries are under a responsibility to ensure the safekeeping of assets of an AIF and this includes assets provided by the AIF as collateral.

Part of this safekeeping requirement is that any financial instruments of an AIF which are capable of being held in custody must be held by a depositary or a delegate of the depositary.

The AIFMD safekeeping requirements impact the business model, operational and collateral arrangements which have traditionally been entered into directly between an AIF and a prime broker. The legal and practical issues which arise are largely based around two concepts:

1. the models for safekeeping of financial instruments held in custody which are subject to collateral arrangements; and
2. how assets are re-hypothecated.

Models for safekeeping

There are two main models envisaged for the safekeeping of financial instruments of AIFs held by depositaries that are subject to collateral arrangements.

Model 1

Model 1 envisages that the depositary appoints a collateral-taker as a delegate to perform safekeeping duties under the AIFMD. This is on the basis that the depositary is satisfied that the collateral-taker could perform the required safekeeping duties adequately. The safekeeping duties that the delegate would need to perform are:

- Maintaining accurate records of AIF assets and segregated accounts;
- Conducting regular reconciliations between its accounts and those of its appointed sub-custodians;
- Exercising due care to ensure a

Key issues

- Depositaries are required to hold in custody all financial instruments capable of being held in custody regardless of whether they are provided as collateral.
- Collateral takers will require depositaries to provide arrangements for accessing the collateral provided.
- Collateral takers can potentially hold collateral themselves if they also provide delegated safekeeping functions.

high level of investor protection;
- Assessing relevant custody risks throughout the custody chain;
- Establishing organisational arrangements to minimise the risk of loss of AIF assets; and
- Verifying the ownership rights of the AIF for the financial instruments held.

As the depositary is responsible for complying with the AIFMD's safekeeping duties for financial instruments held in custody, even when it has delegated its safekeeping functions to a sub-custodian, it will also be responsible for ensuring that the delegate (and any sub-delegates) complies with the provisions of the AIFMD so long as the financial instruments remain assets of the AIF.

Model 2

Model 2 envisages that the depositary holds assets of the AIF itself (or in its own custody network) and establishes mechanisms in order for a collateral-taker, such as a prime broker to exercise a right of use of assets, without delegating custody functions under the AIFMD. This model gives the depositary greater control over the safekeeping of AIF assets, regardless of whether the assets are subject to financial collateral arrangements.

Use of assets

Where assets are provided by an AIF as collateral, it is normally expected that these can be used by the collateral-taker before any default and that a collateral-taker is only required to return equivalent assets.

Provided that the AIF gives a right of use over the assets it offers as collateral, there is nothing in the AIFMD which would prevent a collateral-taker from being able to use or re-hypothecate such assets consistently with those rights.

Model 1

Model 1 would allow the collateral-taker, who holds the assets provided as collateral, to use those assets as it sees fit pursuant to its collateral agreement. The role of the depositary is limited, it would monitor the collateral-taker's use or re-hypothecation of collateral above any agreed thresholds in the collateral agreement.

Model 2

The depositary would have to play a more active role in managing the collateral relationship between the AIF and the collateral-taker to whom the AIF has provided collateral. The depositary would transfer collateral out of its accounts to the collateral-taker upon the instructions of the AIF and receive assets back into custody if they are returned to the AIF from the collateral-taker.

Excess re-hypothecation

The AIFMD makes a depositary responsible for loss of financial instruments held in custody regardless of whether the depositary has delegated the safekeeping of the assets to a sub-custodian.

In relation to collateral, the use of financial instruments held in custody provided as collateral gives rise to risk of loss should the collateral-taker fail to return the financial instruments (for example on its insolvency). Financial instruments posted as collateral will remain held in custody by the depositary (or delegated sub-custodian) until any right of use granted by the AIF is exercised.

Any transfer of title pursuant to a collateral agreement would not be considered a loss of a financial instrument since the transfer is at the instructions of the AIF. If there is a subsequent loss when the asset has been used by the collateral-taker this is not a loss of the depositary.

Model 1

Under Model 1 the sub-custodian collateral-taker will have all the AIF's financial instruments held in custody. Therefore, it could have possession of more than the amount which can be used or re-hypothecated. In this situation, the depositary would have to monitor whether the collateral-taker uses or re-hypothecates more collateral than it is entitled to under the collateral agreement.

Model 2

This model presents less opportunity for a collateral-taker having access to more of the AIF's assets than have been provided purely for the purposes of collateral and re-hypothecating above agreed limits. By interposing the depositary between the AIF and the collateral-taker, the depositary can ensure that only assets which are instructed to be transferred pursuant to a collateral agreement are used by the collateral-taker.

By acting as an intermediary in the collateral arrangements, the depositary would be taking on more obligations to police the collateral agreement between the AIF and the collateral-taker; however, this may ensure a greater level of protection for the AIF and its investors from loss due to assets being used as collateral when they should not have been.

This briefing paper is part of a series of five papers which summarise key issues that the AGC has been considering in relation to the AIFMD.