

AIFMD – "Look-through" obligations relating to CISs and SPVs

Directive 2011/61/EU on Alternative Fund Managers (AIFMD) includes measures designed to ensure that assets held by an alternative investment fund (AIF) are not held through legal or financial arrangements that would avoid the requirement for a depositary to perform safekeeping functions for such underlying assets.

Depositaries will be required to "look-through" certain legal or financial structures to underlying assets in order to ensure that such underlying assets are appropriately subject to the safekeeping requirements of the AIFMD.

"Look-through"

Depositaries have a duty to safekeep an AIF's assets, both for financial instruments held in custody and for other assets. This duty may be extended to cover those assets which are held by funds or SPV structures which an AIF controls.

The situations where depositaries may need to "look-through" to underlying assets in respect of its safekeeping obligations are likely to arise in respect of:

- fund-of-funds structures – where a single AIF acquires holdings in a number of other funds;
- private equity structures – where the target investment will typically be held via an SPV or series of SPVs; and
- various other SPV structures.

Control

Whether a depositary must look through to the assets of any underlying fund/SPV structure of an AIF client depends upon whether or not the AIF client, or its manager,

controls the underlying fund/SPV structure.

The concept of control in the AIFMD is based on accounting consolidation tests. These tests look for:

1. voting control;
2. the right to exercise dominant influence over the underlying fund/SPV; or
3. the right to appoint or remove a majority of members on the administrative or supervisory bodies of the underlying fund/SPV.

The "look-through" requirements therefore seek to ensure that the AIF's depositary safekeeps the assets of the underlying fund/SPV structure

in situations where the AIF or its manager would otherwise have the ability to obscure the affairs of the underlying funds/SPVs.

Control, for the purposes of "look-through", is both direct and indirect. This means that depositaries will have a responsibility to ensure safekeeping of such assets as far down the chain of control as is necessary until the tests for control are no longer met.

Where "look-through" applies, it is only in respect of safekeeping duties and not in relation to a depositary's other obligations under the AIFMD. This means that depositary duties such as cash monitoring, verification of valuation procedures of shares or units, ensuring appropriate

Key issues

- Depositaries' safekeeping obligations apply on a "look-through" basis to all assets of underlying fund/SPV structures controlled directly or indirectly by the AIF or its manager.
- Key criterion is the control the AIF has over the underlying fund/SPV.
- "Look-through" requirements will not apply where the underlying fund/SPV has its own depositary.
- The liability regime does not apply on a "look-through" basis.

reconciliation of subscriptions and redemptions, detecting timely settlement of transactions and ensuring appropriate application of income distribution would all not apply in respect of the assets of the underlying fund/SPV.

The circumstances in which "look-through" obligations apply to other assets is narrower than the corresponding provision for financial instruments held in custody because, in addition to the requirement that the relevant structure is controlled directly or indirectly by the AIF, the structure must also be established by the AIF or its manager for the purpose of investing in the underlying assets.

Therefore, where an AIF acquires a controlling interest in a fund/SPV structure without the AIF establishing the underlying fund/SPV or acquiring it purely for the purpose of investing in the underlying asset, the depositary will not be subject to the "look-through" obligations which would otherwise arise. This may occur, for example, where an AIF has a minority investment in an underlying fund and, due to redemptions of other subscribers, becomes the majority subscriber without actively acquiring any further holdings. This may prove difficult for depositaries to confirm, however, as it is partially a qualitative test based on the AIF's intentions.

Safekeeping requirements

Financial instruments held in custody

Where "look-through" applies under the AIFMD, the effect is to require the depositary to comply with the same safekeeping obligations for financial instruments held in custody as if the depositary were holding the financial instruments of the underlying fund/SPV structure directly.

Depositaries may have difficulties performing these obligations given that there is no direct contractual

relationship between itself and the underlying fund/SPV structures. Therefore, it may need to rely on the cooperation of the AIF client and its ability to exercise its control over the underlying fund/SPV.

Other assets

"Look-through" obligations in respect of other assets means that depositaries will need to ensure that the other assets of underlying funds/SPV structures are subject to the same ownership verification and record keeping requirements as the depositary's AIF client.

As part of the requirements on ownership verification and record keeping for other assets, depositaries will need to be put in place procedures to ensure that registered assets held by underlying funds/SPV structures cannot be assigned, transferred, exchanged or delivered without the depositary being informed.

As with financial instruments held in custody, depositaries are likely to have difficulties performing these obligations given that there is no direct contractual relationship between itself and the underlying fund/SPV structures. Reliance on the AIF or its manager may be necessary to ensure that information is provided and procedures can be put in place.

Alternative depositaries

The "look-through" safekeeping, verification and record keeping requirements do not apply to either fund-of-funds or master-feeder structures where the underlying fund has its own depositary which provides the safekeeping of financial instruments held in custody or ownership verification and record keeping of other assets in respect of that underlying fund. Additional conditions exist where the depositary is outside of the EU.

The "look-through" obligations do not apply where the underlying fund has a

depositary which conducts safekeeping, even if the assets of the underlying fund are registered in the name of underlying fund rather than the depositary so cannot be held in custody.

The depositary of the underlying fund is only required to safekeep the fund's assets appropriately. There is no requirement for the depositary to be subject to the full suite of AIFMD requirements, such as cash monitoring obligations.

Loss Liability

The AIFMD makes a depositary responsible for loss of financial instruments held in custody, unless the loss is caused by an "external event".

When a depositary has to "look-through" to the assets of an underlying fund/SPV, the loss liability regime for financial instruments held in custody should not apply as such liability has not been specifically included by either the AIFMD or ESMA's delegated regulation. Therefore, any liability to a depositary for loss of an underlying fund/SPV's financial instruments held in custody would be on the basis of negligence or wilful default of its AIFMD obligations and not strict liability for everything other than an "external event".

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.