

AIFMD Review – what is changing for depositaries and what has been parked for now?

The long awaited AIFMD Review legislative **proposal** was finally released by the Commission on 25 November 2021 (the Proposal). The Proposal puts forward amendments to both the AIFMD and the UCITS Directives in order to align the requirements.

The Commission's review of the scope and functioning of the AIFMD framework has led it to conclude that the AIFMD standards for ensuring high levels of investor protection are mostly effective. In the context of the depositary regime, whilst the Commission believes that it safeguards investor interests and supports the orderly functioning of the investment funds market, it has concluded that investor interests could be better served if the AIFMD rules were amended to increase efficiencies in the market for depositary services.

In this bulletin, we consider the areas where the Commission has proposed change in the context of the depositary regime before looking at the elements of the Commission's consultation of last October that have not been taken forward.

Background

The AIFMD sets out the types of firms that may act as depositaries to AIFs; the functions which a depositary must perform; and the circumstances in which a depositary is liable for causing loss to investors, the AIF or the AIFM. It is the AIFM that is responsible for ensuring a depositary is appointed in accordance with the requirements of the AIFMD for each AIF it manages.

On 22 October 2020, the European Commission launched its public consultation on the review of AIFMD (the Consultation). The Consultation followed the Commission's review report from June of the same year where the Commission stated that the provisions governing the functions and liability of depositaries had been effective elements of the regime for promoting investor protection, although there were areas that could benefit from targeted clarifications. The Commission had also highlighted their concerns regarding the lack of a depositary passport, particularly given the impact it has on smaller depositary markets.

The Consultation closed on 29 January 2021 with 132 responses. According to section 3 of the Proposal, the majority of the stakeholders (approximately 70%) and ESMA (in its opinion) supported bringing central securities depositories (CSDs) acting outside their issuer CSD capacity into the scope of the rules on delegation of safekeeping functions. On the issue of smaller depositary markets, public authorities from the Member States indicated in their response to the Consultation that they supported retaining the option to empower national competent authorities to permit procuring depositary services cross-border. The majority of the respondents did not support introducing the depositary passport citing the risk of a concentration of the depositary market, lower investor protection and supervisory challenges. We consider the Commission's proposals related to depositary services in more detail below.

What is changing for the depositary regime?

Central Securities Depositories (CSD)

CSDs are not considered delegates of the depositary in the chain of safekeeping under the current framework. This legal position can restrict the flow of information between the custodian of an AIF's or UCITS' asset and the depositary where the CSD is safekeeping the assets in a chain of delegations but acting outside their issuer CSD capacity. This could undermine investor protection and is arguably an unfair outcome where the CSD in that capacity (as opposed to its issuer CSD capacity) could be seen as competing with non-CSDs in the market for custody services.

As part of the Consultation, it was also considered whether depositaries delegating custody of AIF or UCITS assets to CSDs should perform due diligence. Following the Consultation, it was decided that this would be excessive, given that authorised CSDs are already subject to stringent sectoral regulatory requirements and supervision. Therefore, the Proposal focuses on including the CSDs in the custody delegation chain without imposing unnecessary due diligence requirements on depositaries.

The Proposal suggests that the fifth subparagraph of Article 21(11) of AIFMD is amended to bring CSDs (provided the relevant CSD is not acting in the capacity of an issuer CSD i.e. where they are effectively providing competing custody services) into the custody delegation chain. This change is designed to level the playing field among the custodians and ensure that depositaries have access to the information needed to carry out their duties. A similar amendment is proposed for the UCITS Directive in relation to paragraph 4 of Article 22a.

Article 21(11) of AIFMD and Article 22a of the UCITS Directive are also amended to make clear that the obligation on the depositary to carry out ex-ante due diligence is waived where it intends to delegate safekeeping to a CSD not acting in an issuer CSD capacity.

Depositary passport

Both AIFMD and the UCITS Directive require the depositary to have its registered office or a branch in the same country as the fund. Non-EU AIFs can have a depositary established in the relevant third country only if certain additional conditions are met. The introduction of a depositary passport would allow for the cross-border provision of depositary services, based on a harmonisation of depositary obligations which at present often differ across Member States. As part of the Consultation, the Commission once again considered the question of whether to introduce a depositary passport but has concluded that this option is still not feasible given the absence of EU harmonisation of securities and insolvency laws.

The retained option proposes permitting cross-border access to depositary services until further harmonisation at the Union level becomes feasible. Section 3 of the Proposal states that the amendment is *“expected to generate savings for both depositaries and the users of the depositary services, including smaller AIFMs. The one-off fees for new licence and the annual licence fees for depositaries range respectively between € 6000 and € 9200 depending on the Member State and between € 4,400 – € 9,400 depending on the Member State. The increased competition between depositary service providers is likely to exert downward pressure on the service price”*.

Article 61(5) of AIFMD included a derogation enabling the provision of cross-border services until 22 July 2017. The Proposal amends that article by removing reference to any date, thereby enabling competent authorities of the home Member State of an AIF (or in a case where the AIF is not regulated, the competent authorities of the home Member State of an AIFM) to allow depositary services to be procured in another Member State until a time when the Commission deems it appropriate to introduce a depositary passport.

The Commission is clear that if amendments to AIFMD mean that it continues to be possible to appoint a depositary in another Member State, that change should be accompanied by increased supervisory reach. The Commission has therefore also proposed amending Article 21(16) to ensure that depositaries cooperate not only with their competent authorities but also with the competent authorities of the AIF that has appointed it as a depositary and with the competent authorities of the AIFM that manages the AIF.

Third country depositaries

For depositaries established in a third country, proposed amendments to Article 21(6)(c) and Article 21(6)(d) would mean that they could not be established in jurisdictions:

- identified as high risk countries (pursuant to Directive (EU) 2015/849(AMLDIV)) rather than listed as a non-cooperative country and territory by FATF; or
- identified as non-cooperative for tax purposes by the EU Council.

What has not been included in the Proposal?

Tri-party collateral management services

The Consultation focused quite closely on the provision of tri-party collateral management services and whether the AIFMD framework should be updated to specifically define those services and provide more specific rules for the delegation process, where the assets are in the custody of tri-party collateral managers.

Since the AIFMD came into force and the introduction of a number of regulations post the financial crisis (e.g. EMIR and the resulting mandatory initial and variation margin requirements), institutions have been required to focus more intensely on their collateral management practices, expanding the use of collateral, increasing the frequency of assessment and maximising the values of collateral exchanged. Increasingly, buy-side market participants have turned to the triparty model where the triparty agent (acting as a neutral party) manages the collateralisation of exposures resulting from trading activities between two counterparties.

The Commission had been keen to use the Consultation to understand which aspects should be explicitly regulated by the AIFMD but the Proposal is silent on this point and gives no indication as to whether this will be an area that the Commission focuses on again at a later date. This is likely to be welcomed by many participants in the industry, as an overly prescriptive regulatory regime could have undermined some of the commercial and operational efficiencies, and automation, of collateral management, that are the essence of the services they entail.

Prime brokers

Another area of focus within the Consultation had been in the context of prime brokers that have been appointed as sub-custodian to a depositary. In such a scenario, the prime broker must provide to the depositary of the AIF, no later than the close of the next business day to which it relates, a statement (in a durable medium) which contains certain prescribed information. The Consultation sought stakeholder views on whether the relevant rules were clear and whether depositaries face any difficulties in obtaining the required reporting from prime brokers. If difficulties have historically been identified, stakeholders were requested to suggest additional measures that are necessary at the EU level to address those difficulties. Similar to tri-party collateral management services, this is an area where the Proposal is silent. Again, this is likely to be welcomed by market participants, as they are already subject to a number of rules in this area and where arguably commercial and competitive pressures would achieve the necessary transparency in any event.

Practical comment

The questions posed in the Consultation suggested that a number of areas related to the depositary regime were under consideration. The resulting amendments as set out in the Proposal are relatively limited in comparison and as a result are likely to be welcomed by the industry.

It will come as no surprise that the Proposal delays the decision on whether to introduce a depositary passport. There has long been a discussion in the EU on the merit of a depositary passport – in a letter to the Commission last August, ESMA stated that the debate had been running “since the UCITS II debate in 1993 at least”. The lack of harmonisation across Member States is seen as the most important barrier – particularly in relation to securities and insolvency laws, which can cause significant issues in the case of insolvency, but also in relation to regulatory frameworks in terms of custody regulations and investor protection.

Next steps

It is expected that political agreement between the Council and the European Parliament will be reached in the second half of 2022, which would likely lead to publication in the EU Official Journal in early 2023 and entry into application in

early 2025. The discussions in the Council are expected to start as early as 2 December 2021 with a first reading of the text, to allow for the negotiations to begin in early January 2022.

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