France: AIFMD Rules on the Depositories to Alternative Investment Funds

The 2011 Alternative Investment Fund Managers Directive (AIFMD) subjects all managers of alternative investment funds (AIFs) to harmonised regulatory standards across the EU. To this end, it establishes (a) a passport system for the marketing of AIFs in the EU, and (b) a unified legal framework to monitor and supervise alternative investment fund managers (AIFMs). An important feature of the AIFMD is a set of rules relating to the appointment, functions and liability of depositaries of AIFs. While the AIFMD outlines the overall framework of the regime, a Level 2 Regulation provides more detailed rules.

A. The AIFMD Regime

Appointment of Depositaries

An AIFM needs to appoint a single depositary for each AIF it manages. Possible depositaries are EU credit institutions, EU investment firms, or institutions authorised to act as a UCITS depositary. For non-EU AIFs, the depositary may also be an institution deemed equivalent to an EU credit institution or EU investment firm as long as it is subject to effective prudential regulation (e.g. minimum capital requirements) and supervision that has the same effect as EU law. The Level 2 Regulation spells out the criteria for evaluating third-country prudential and supervisory regimes. Since private equity funds do not have recourse to third-party custodians, EU member states may authorise entities that perform the depositary functions as part of their business activities (e.g. law and investment firms) to be depositaries for AIFs provided that the investment lock-up periods be at least five years, or the funds invest in illiquid assets for which custody may be unsuitable. For EU AIFs, the depositories must be established in the home member state of the AIF. Depositories to non-EU AIFs need to be established either in the fund's home third country, in the home member state of the AIFM, or in a so-called non-EU AIFM's member state of reference.

Depositary Contracts

The appointment of the depositary to an AIF must be governed by a written contract. Pursuant to the Level 2 Regulation, if allowed under national law, the contract may take the form of a framework agreement between an AIFM and the depositary that covers all AIFs that the AIFM manages and to which that depositary is appointed.

Functions and Obligations of Depositaries

The depositary fulfils three functions with respect to the AIF: (a) safekeeping its assets; (b) supervising compliance with its constitutional documents and applicable laws and regulation; and (c) monitoring its cashflows.

Safekeeping

The safekeeping function involves either custody or record-keeping, depending on the type of asset owned by the AIF. According to the Level 2 Regulation, custody comprises proper asset segregation on the depositary's or its delegate's books, due care of assets held in custody and assessment and scrutinising custody risk along the custody chain. The custody function concerns all assets that can be held in custody, be it by physical delivery or through registration in a financial instruments account in the depositary's books. The Level 2 Regulation specifies the types of financial instrument which are subject to the depositary's custody duty (i.e. transferable securities, money market instruments and units in collective investment undertakings, which are registered or held directly or indirectly in an account in the name of the depositary). All assets that cannot be held in custody fall under the scope of the record-keeping function. The depositary's duties with respect to such assets are to keep up-to-date records and to verify ownership, thereby drawing on information to be provided by the AIF or AIFM or on external evidence. The Level 2 Regulation contains reporting obligations for prime brokers appointed by an AIF or AIFM, conferring the primary obligation on the AIFM to provide the depositary with the mandated information.

Oversight

Pursuant to its oversight obligations, a depositary must ensure that dealings in units or shares of the AIF are consistent with the AIF applicable rules; ensure unit or share valuation is done in line with the AIF applicable rules and the AIFMD valuation principles; carry out the instructions of the AIFM provided they be in accordance with the AIF applicable rules; ensure that in transactions involving the AIF's assets, any consideration is remitted to the AIF within usual time limits; and ensure that the AIF's income is applied in accordance with the AIF's rules. Under the Level 2 Regulation, while the exercise of the oversight function should be proportionate to the estimated risks of the relevant AIF and without prejudice to the depositary's ability to conduct appropriate ex-ante verifications, most verification checks will be ex-post second level controls.

Cash Monitoring

Being complementary to the oversight function, the cash monitoring obligations require the depositary to have a full overview of the cash position and cash movements of the AIF, including subscription monies. In line with the Level 2 Regulation, the depository must effectively implement and periodically review cash monitoring procedures, in particular with respect to reconciliations, and the notification of the AIFM of any identified discrepancies that have not been rectified. In cases where cash accounts are in the name of the AIF or the AIFM on behalf of the AIF, the depositary depends on the AIFM's compliance with its obligations to provide accurate information in a timely manner.

Delegation

A depositary may only delegate its oversight responsibilities. In order to obtain approval, the depository needs to demonstrate, inter alia, that the request is based upon an objective reason and does not represent an attempt to circumvent the AIFMD requirements. Moreover, it must exercise all due skill, care and diligence in the selection, appointment and ongoing review and monitoring of its delegates, so as to ensure that they meet, at all times during the performance of the delegated tasks, certain specified standards (especially in terms of expertise, prudential regulation and supervision and segregation of assets).

Depositary Liability

The AIFMD sets out a strict standard of liability for depositaries to AIFs or their investors for instruments they hold in custody. The Directive stipulates that they shall be liable for the negligent or intentional failure to properly fulfil their obligations, obliging them to replace the instrument or pay the value to the AIF without undue delay. A depositary may only avoid this strict liability standard by providing exonerating evidence. It must prove cumulatively that the loss resulted from an external event (i), which was beyond its reasonable control (ii) and the consequences of which would have been unavoidable despite all reasonable efforts (iii). In cases where the loss has been caused by a delegate, the depositary can avoid liability if it can prove cumulatively that it has met all AIFMD requirements pertaining to delegation (i); the written contract between the depositary and the delegate transfers liability to the delegate (ii) and permits direct enforcement by the AIF against the delegate (iii); and the depositary's contract with the AIF expressly allows such an exemption and establishes the objective reason for it (iv). Finally, in cases where the delegation is due to a third-country custody requirement, the depositary can avoid liability if the AIF's constitutional documents expressly allow for an exemption from liability in such circumstances (i); the delegation requirements associated with a third-country custody requirement have been met (ii); investors have been informed in advance of the exemption and its justification (iii); and the depositary contract and delegation contract contain the required transfer, enforcement and exemption provisions (iv). Other than with respect to its custody obligations, a depositary is liable to the AIF or its investors for all losses caused by its negligent or intentional failure to fulfil properly its obligations under the AIFMD. As regards enforcement, liability to the investors of the AIF may be invoked either directly or indirectly through the AIFM, depending on the legal relationship between the depositary, the AIFM and the investors.

B. France

The French asset management industry belongs to the largest in the world, with assets under management by collective investment schemes (AIFs and UCITS) of €1,929 billion at the end of 2017 . In France, the Monetary and Financial Code (MFC) and the Ordinance No. 2016-312 of 17 March 2016 contain the relevant rules pertaining to a depository to an investment fund (AIF and UCITS). The Ordinance implements under French law the provisions of the UCITS V Directive, which aims to harmonise the provisions on depositaries with those spelt out in the AIFMD. Pursuant to the MFC, the depositary needs to have its registered office in France and be chosen from a limited list of entities, including credit institutions or investment firms authorised to perform custody activities by the French Prudential and Resolution Supervisory Authority – the national regulator in charge of supervising credit institutions and investment firms. The depositary is entitled to delegate total or partial custody of the assets of the investment funds to a third party but remains responsible for the return of any fund assets that may be lost while held in sub-custody. Any limitation of such liability may be contractually established for AIFs (but not for UCITS).Julien Dif[1]The French Asset Management Association, Annual Report for 2017.