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The AIFM, Depositary and the Prime Broker in the Prime Brokerage relationship¹

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INTRODUCTION

Depending upon whether a prime broker is solely acting as a counterparty or as a counterparty and a depositary/sub-custodian, the prime broker may either enter into a prime brokerage agreement with the alternative investment fund manager (the “AIFM”) for acting as a counterparty and an agreement with the depositary for acting as a sub-custodian. Often this results in a tri-partite agreement between the AIFM, prime broker and the depositary.² The checks and balances under the AIFM Law³/AIFMR⁴ require the AIFM, prime broker and depositary to fulfil certain duties in the prime brokerage relationship. The duties of AIFMs regarding its organization and disclose/reporting need to be proportionally applied, whereas the depositary’s (or depositary division of the prime broker’s) duties depend on whether and to what extent the prime broker holds financial instruments that can be held in custody.

This article discusses the role and the duties of the AIFM, the depositary and the prime broker duties in the prime brokerage relationship under the AIFM Law/AIFMR. In particular, the frictional boundaries between the prime broker’s counterparty and depositary functions will be highlighted. This contribution concludes by discussing prime broker models that are used in practice to resolve these frictional boundaries.

1. THE ROLE OF THE AIFM, PRIME BROKER AND DEPOSITARY

a. The AIFM

AIFMs carry out due diligence and appoint prime brokers as AIF counterparties with whom

a contract is to be concluded.⁵ The depositary may, but is not required to be a party to it.

In selecting and appointing prime brokers, AIFMs should ensure that prime brokers are subject to ongoing supervision, are financially sound and have the necessary organizational structure⁶ appropriate to the services to be provided to the AIFM or the AIF.⁷ The AIFM must for each AIF it manages make available to AIF investors a description of any material arrangements with or changes to the identity of its prime brokers and the way in which conflicts of interest are managed.⁸

The AIFM’s duties upon and during the appointment of a prime broker can be categorized in risk management, compliance duties and reporting/disclosure duties.

The AIFM, as part of its risk management requirements, is, in particular, required to determine, amongst others, the amount of leverage to be employed for each AIF and the extent to which a guarantee or the right to reuse collateral may be granted under a leveraging arrangement.⁹

The use of prime brokers also requires AIFMs to comply with provisions related to, amongst others, inducements, best execution and conflicts of interest.¹⁰

Upon the appointment of a prime broker, various disclosure and reporting obligations of the AIFM are applicable. The AIFM has a reporting duty towards the depositary for the data provided by the prime broker to the depositary.¹¹ This, in particular, enables depositaries that are not a party to the prime brokerage agreement to obtain the information necessary to exercise its safekeeping, cash monitoring and oversight functions.

The AIFM also needs to fulfil various disclosure requirements related to prime brokers towards investors. The AIFM must, for example, in the private placement memorandum describe, amongst others, the type of assets in which the AIF is allowed to invest, investment techniques that are allowed to be employed and investment restrictions.¹²

Besides, the AIFM is obliged to report to the CSSF information regarding substantial leverage being employed, such as leverage reporting, in particular, related to the borrowing of cash or securities and the leverage embedded in financial derivatives.¹³

b. The Prime Broker – Reporting Obligations towards the Depositary

After the AIFM has informed the depositary of the prime brokerage agreement, the prime broker is required to directly report to the depositary. The reporting obligations clearly distinguish upon the functions exercised by the prime broker.

Prime brokers are in relation to their counterparty function required to report:¹⁴

- the value of non-custody (other) assets held as collateral by the prime broker;
- the value of the assets where the right of use has been exercised in respect of the AIF’s assets; and
- to provide a list of all the institutions at which the prime broker holds or may hold cash of the AIF in accordance with the AIFM Law.

Prime brokers appointed as a sub-custodian to an AIF have to report to the depositary the total value of assets held by the prime broker for

the AIF, including values related to, amongst others, cash loans made to the AIF and details of any other matters having a material impact on the value of assets that are being safe-kept by the prime broker as a sub-custodian.¹⁵

c. The Depositary - frictional boundaries between the Prime Broker's Counterparty and Depositary Function

(i) Safekeeping: Scope Financial Instrument held in Custody versus 'Other Assets'

Under the AIFM Law, the relationship between the depositary and prime broker depends upon the type and status of assets held by the prime broker.

Prime brokers may not hold financial instruments that can be held in custody without being appointed as a depositary or as a sub-custodian.¹⁶ Not only the qualification of assets as financial instruments that can be held in custody but also the status of these financial instruments are important to determine whether a prime broker is obliged to be appointed as a depositary itself or as a sub-custodian. Financial instruments that can be held in custody may be unencumbered, encumbered (subject to a security interest or right of re-hypothecation in favour of the prime broker) or on title transfer. The holding of financial instruments that can be held in custody on an unencumbered basis is reserved for depositaries and its sub-custodians. Financial instruments that can be held in custody that are encumbered, i.e. subject to a security interest or right of re-hypothecation in favour of the prime broker, fall within the depositary's custody function as long as the AIF (or the AIFM on its behalf) has retained the title over these financial instruments. Assets that, for instance, are merely pledged to the prime broker to secure the AIF's debt may not be held by a prime broker without the prime broker being appointed as a depositary or a sub-custodian. Financial instruments that are re-hypothecated, i.e. they are not merely subject to a right of reuse but the right of reuse is being exercised, fall outside the scope of the depositary's custody duty. The AIF (or the AIFM on its behalf) has lost title over these financial instruments. Similarly, financial instruments that have been provided to the prime broker on title transfer also do not fall within the scope of the depositary's custody duty. The AIF (or AIFM on its behalf) loses its proprietary claim to the assets in return for a contractual claim on the prime broker for re-delivery. Prime brokers can, thus, hold financial instruments on title transfer without being appointed as a depositary or a sub-custodian.

Other assets than financial instruments held in custody, such as derivatives, are merely subject to a record-keeping duty. The depositary (or the prime broker's depositary division) will need to verify ownership of these assets.

This may not be exercised by the counterparty division of the prime broker. Prime brokers are only required to be appointed as a depositary or a sub-custodian for financial instruments held in custody.¹⁷ Prime brokers may, thus, control and retrieve other assets, such as derivatives or financial instruments that can be held in custody on title transfer or that are re-hypothecated without becoming a sub-custodian of the depositary (depositary's division of the prime broker).¹⁸ The depositary remains to be responsible for performing the safekeeping duty of verification for these assets.¹⁹

(ii) Oversight Duties

The type of assets, encumbered by security interests or a right of reuse or not, does not have an impact on the oversight duties to be performed by the depositary. The depositary or the depositary division of a prime broker are obliged to carry out the oversight functions and may not delegate this task to third parties.²⁰

(iii) Cash Management - Cooperation between the Prime Broker and the Depositary

The nature of cash determines the duties of a depositary (or the segregated division of a prime broker carrying out depositary functions) towards it. Cash, qualifying as "other assets", can either be under the depositary's record-keeping²¹ and/or cash monitoring²² function. Prime brokers acting as a counterparty to an AIF do not need to be appointed by the depositary as sub-custodian in order to "control or retrieve" AIF's cash. The cash flow monitoring of the cash of an AIF being held by prime brokers needs to be conducted by the depositary or the segregated division of a prime broker carrying out depositary functions. Cash flow monitoring includes several duties that are undertaken by the depositary to oversee the AIFM. For both functions, the depositary (or the depositary division of the prime broker) will need all relevant information from the AIFM and third parties (prime brokers) to comply with its obligations.

2. PRIME BROKER MODELS: THE DEPOSITARY - PRIME BROKER RELATIONSHIP

Following the adoption of the AIFM Law, several prime broker models have emerged over the past years.²³ The more financial instruments are being held in custody by the prime broker as a sub-custodian, the more risk the depositary has under the "guarantor liability" regime. At the other hand, the more financial instruments are being held by the depositary's custody network, the less willing the prime broker is to provide leverage to the AIF as the prime broker has less grip on the

AIF's assets and the execution and settlement of transactions will be more complex. Within both broad categories, depositaries and prime broker have been seeking to balance the risks by developing a few prime brokerage models that will be (non-exhaustively) discussed.

a. The Prime Broker as Depositary

Under the AIFM Law, a prime broker may carry out both depositary and counterparty functions as long as the functional and hierarchical separation of both functions is being preserved and the prime broker will manage conflicts of interest properly.²⁴ Provided these two conditions are fulfilled, it is irrelevant whether a prime broker is appointed as a depositary (the "prime depositary" model) or a depositary is being appointed as a prime broker (the "depositary prime" model).²⁵ The latter model has, however, not proven to be welcomed in practice as taking upon the counterparty function by depositaries requires them to invest in risk management technology and to retain more own capital under CRD IV and the CRR.

b. The Prime Broker as Sub-Custodian

Instead of being appointed as a depositary, prime brokers may also be appointed by depositaries as a sub-custodian. The depositary liability standard and the difficulties of discharging liability under the AIFM Law have led to some variations that are applied in practice of prime broker models in which prime brokers are appointed as sub-custodians.

There are two broad categories of prime broker models that have emerged in which prime brokers that are appointed as a sub-custodian use their own sub-custodian network or the sub-custodian network of the depositary.

(i) The Prime Broker using its own Sub-Custodian Network

Under the first category, the depositary of an AIF appoints the prime broker as its sub-custodian, whereas the prime broker uses its own sub-custodian network.

The first sub-model used in this category is the appointment of a prime broker as a sub-custodian without contracting a liability discharge or an indemnity clause for lost financial instruments that can be held in custody. Without any liability discharge or indemnification from the side of the prime broker, the depositary bears the risk of the loss of all financial instruments that can be held in custody. The problem in this regard is that under the AIFM Law not the depositary but the AIFM is the primary party responsible for appointing the prime broker (as a counterparty) that carries out due diligence upon the appointment and on an ongoing basis.²⁶ This problem is accelerated by the fact that the due diligence duty that the AIFM is carrying out on the prime broker only con-

cerns its function as a counterparty and not as a sub-custodian. The depositary is responsible for the appointment of the prime broker that are acting as counterparty as a sub-custodian and may not refuse the appointment of prime brokers that fulfil the requirements laid down in Article 19(4)(b) and (11) AIFM Law. The depositary under this model retains liability and is dependent upon the information being provided by the prime broker.²⁷ In addition, it will likely conduct extensive ongoing due diligence related to the prime broker's role as sub-custodian. Especially, when the prime broker is using various sub-custodians in risky markets. To address this liability issue, two other variations have been developed in practice.

The second sub-model is the "liability discharge" model in which upon the appointment of the prime broker as a sub-custodian, the depositary and the prime broker agree upon a contractual discharge of liability.²⁸ A contractual discharge of liability transfers the liability risk for lost financial instruments that can be held in custody from the depositary to the prime broker as sub-custodian. The prime broker as sub-custodian may further transfer this risk "down the chain" by agreeing upon a contractual discharge of liability with any of its sub-custodians in its network. There are two options that might qualify as an "objective reason" to contract such a discharge by prime brokers. The selection of a particular prime broker by an AIFM that is also appointed as a sub-custodian by a depositary is considered to be sufficient as an objective reason for the delegation of custody tasks and a valid contractual discharge of liability being assumed by both the depositary and the prime broker.²⁹ Another objective reason could be that any of its sub-custodians is established in a third country that does not satisfy the AIFM Law criteria and for which no alternative in the respective market is available. This sub-model, however, depends upon the willingness of prime brokers to accept liability for the use of their own sub-custodian network.³⁰

The third sub-model is the "indemnification model".³¹ This model emerged in practice as the AIFM Law heavily restricts the "liability discharge model". To address this issue, depositaries and prime brokers as sub-custodians may agree upon an indemnity clause which stipulates that depositaries have to be compensated for any *guarantor liability* triggered for lost financial instruments that can be held in custody in the prime broker's sub-custodian network have to be compensated by the prime broker. There are, however, severe disadvantages for the depositary under this model. Depositaries accepting indemnity clauses have to accept counterparty risk to the prime broker for the contractual indemnity offered. The indemnity clause does not offer protection to

depositaries for financial instruments that can be held in custody that are lost as a result of the bankruptcy of the prime broker. Finally, prime brokers may be unwilling to provide contractual indemnity as this may have severe implications on the capital structure of the prime broker. Depending upon the particular relationship, depositaries and prime brokers might consider to use other prime broker models that are available.

(ii) The Prime Broker using the Depositary's Sub-Custodian Network

Under the second category, the depositary appoints the prime broker as a sub-custodian, whereas the depositary retains its liability. In turn, the prime broker is under this model only allowed to appoint sub-custodians of the depositary's sub-custodian network. All the assets of the AIF concerned are, thus, safe-kept by the depositary's sub-custodian network. Given the oversight that the depositary has over his network, the depositary is able to mitigate liability issues better than in the case assets are kept in the prime broker's sub-custodian network. All settlement and clearing transactions under this model remain, however, to be directed by the prime broker. The downside of this model is that the prime broker will need to invest in new sub-custodian networks, in addition to, its current network for non-EU AIFs. In addition, the depositary's sub-custodian network might not suit the investment policies of the AIF as much as the sub-custodian network of the prime broker. The latter issue might be solved by the prime broker appointing a third-party (global custodian) that is affiliated with the depositary. Global custodians might have more suitable sub-custodian networks for providing access to a larger amount of markets.

c. The Prime Broker as Counterparty

Prime broker may also solely act as a counterparty to an AIF without being appointed as a depositary or a sub-custodian for performing the custody functions.³² Under this model, the depositary and other sub-custodians will be responsible for the safekeeping of assets. The prime broker may under this arrangement not hold any assets that should be held in custody provided that the prime broker is not appointed as a depositary or sub-custodian. This allows the depositary to remain in control over all of the AIF's assets and it can, therefore, retain liability. This requires, however, the prime broker to transfer the AIF's financial instruments that can be held in custody to the depositary's network on a daily basis. The prime broker still requires that an AIF provide its assets as collateral to the prime broker as collateral taker. The AIFM Law, however, requires these assets to be kept in custody as long as the AIF owns the financial instruments. Collateral arrange-

ments can be dealt with in several ways.³³

One option is that the AIF's depositary or one of its sub-custodians acts as agent for the prime broker as collateral taker (the "prime custody" model). Under this model, security interests are vested on the financial instruments that can be held in custody by means of an control agreement or earmarking in favour of the prime broker as collateral taker. This model avoids the prime broker and the depositary taking principal risk at the same time.³⁴

Another possibility is that prime brokers require financial instruments that can be held in custody to be title transferred to them to serve as collateral (the "title transfer model").³⁵ As the AIF no longer owns financial instruments on title transfer, financial instruments are under the AIFM Law not anymore being considered as assets that can be held in custody. Prime brokers may, thus, hold these assets without being appointed as a depositary or a sub-custodian. Under this model, AIFs need to accept considerable counterparty risk. AIFMs would need to carry out intensified ongoing

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due diligence on the prime broker to make the counterparty risk acceptable.

The third possible option is that the prime broker only holds and retains security interests on *other assets* than financial instruments that can be held in custody (the “prime only” model).³⁶ Under this model, the AIF is, however, exposed to the insolvency risk of the prime broker.

The downside of the prime broker only acting as an counterparty in all three sub-models is that the depositary is facing an intra-day *guarantor liability* exposure to the prime broker as the prime broker only transfers the assets to the depositary’s network on a daily basis. For this reason, this model is operationally inefficient for certain type of AIFs, such as long/short hedge fund type of AIFs, that involve multiple instructions/settlements for carrying out a single transaction.

d. The Depositary-Lite Model

Luxembourg and EU-AIFMs marketing non-EU AIFs without a passport in Luxembourg may employ the so-called “Depositary Lite” model.³⁷ Under this model, these type of AIFMs may either appoint a single depositary that performs all duties that, optionally, delegate the safekeeping of financial instruments to a prime broker (the “integrated” model) or take a multiple-provider approach in which the depositary duties are carried out by more than one entity (the “open-architecture” model).³⁸

Under the open-architecture model, in practice the following two sub-models are, amongst others, mostly applied:³⁹

- prime brokers/custodians perform the safekeeping of financial instruments (custody), administrators the cash flow monitoring and the verification of other assets (record-keeping) functions and a depositary is appointed to perform oversight duties; or
- prime brokers/custodians perform the safekeeping of financial instruments (custody) but a depositary is appointed to perform the cash flow monitoring, the verification of other assets (record-keeping) and oversight duties.

CONCLUSION

A prime brokerage relationship involves the AIFM, depositary and the prime broker. The AIFM is responsible for the relationship with the prime broker acting as a counterparty to the AIF, whereas the depositary appoints the prime broker as a sub-custodian. The AIFM responsible for the prime brokerage agreement is required to comply with various organizational requirements related to risk management, compliance and disclosure/

reporting. Prime brokers acting as a counterparty are responsible for reporting assets to the depositary, whereas there are various frictional boundaries between the role of the depositary and the prime broker. Depending upon the type of assets (financial instruments that can be held in custody) and the status of the assets (unencumbered, encumbered or on title transfer), prime brokers are mandatorily required to be appointed as a depositary or as a sub-custodian. Various prime broker models have been developed in practice to solve the frictional boundaries between the depositary and the prime broker that are primarily based on the risk appetite of both.

Notes

- 1 The views expressed in this article reflect some of the author’s experience to date on the subject matter. As the Luxembourg fund market continues to develop – namely in relation to prime brokers – these views may and will most likely continue to evolve in one way or another. This article should not be construed as legal advice rendered by the author or by NautaDutilh Avocat Luxembourg S.à r.l., nor should it be interpreted as reflecting the views of NautaDutilh Avocat Luxembourg S.à r.l.
- 2 D.A. Zetzsche, (*Prime Brokerage* 581 (D.A. Zetzsche ed., Kluwer 2015).
- 3 “AIFM Law” means the law of 12 July 2013 relating to alternative investment fund managers, as amended.
- 4 “AIFMR” stands for Commission Delegated Regulation (EU) 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.
- 5 Art. 13(3) AIFM Law.
- 6 Art. 20(2)(c) AIFMR.
- 7 Art. 18(3) AIFM Law.
- 8 Art. 21 AIFM Law.
- 9 Art. 14(4) AIFM Law.
- 10 Art. 24, 27, 30-37 AIFMR.
- 11 Art. 90(2)(c) sub-para. 2 AIFMR.
- 12 Art. 21(1) AIFM Law.
- 13 Art. 21(4) AIFM Law.
- 14 Article 91(1) AIFMR.
- 15 Article 91(3) AIFMR.
- 16 S.N. Hooghiemstra, *Depositaries in European Investment Law - Towards Harmonization in Europe* Chapter 4, section 4.3.1.4 (Eleven International Publishing 2018).
- 17 Art. 19(4)(b) AIFM Law.
- 18 Recital 100 AIFMR.
- 19 Art. 19(8)(b) AIFM Law.
- 20 Art. 19(1) AIFM Law.
- 21 Art. 19(8)(b) AIFM Law.
- 22 Art. 19(7) AIFM Law.
- 23 KPMG, *The prime brokerage industry: An exploration of evolving standards – operational accountability, internal controls,*

and transparency, <https://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/the-prime-brokerage-business.pdf> (accessed 5 June 2018).

- 24 Depending upon whether the depositary qualifies as a prime broker under the AIFM Law or not, the depositary needs to comply with the “conflicts of interest management rule” under Art. 19(4)(b) AIFM Law for prime brokers or under Art. 19(10) sub-para. 2 AIFM Law for depositaries.
- 25 The terminology of both terms are adapted from: Zetzsche, *supra* note 2, 601-602.
- 26 Art. 13(3) and 18 AIFM Law.
- 27 Art. 13(3) AIFM Law, Art. 91(1) AIFMR.
- 28 Matheson, *AIFMD Factsheet: Prime Brokers*, http://www.matheson.com/images/uploads/publications/AIFMD_Factsheet_Prime_Brokers.pdf (accessed 5 June 2018).
- 29 See also ESMA, Consultation paper - ESMA’s draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, July 2011, ESMA/2011/209, 390; ESMA, Final report / ESMA’s technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/379, 44-45.
- 30 S.N. Hooghiemstra, *De AIFM-richtlijn en de aansprakelijkheid van de bewaarder*, 6 TvFR 178 (2013).
- 31 BEAMA AIFMD FAQ Deel 1, Q25: Welke ‘Prime Broker’-modellen zijn er nog mogelijk onder de AIFMD?, www.beama.be/nl/faq/aimfd-faq-deel-i (accessed 5 June 2018).
- 32 *Ibid.*
- 33 European Commission, *Commission Delegated regulation (EU) No ... of 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision*, Brussel, 19.12.2012, C (2012) 8370 final, 9.
- 34 J.P. Morgan, *J.P. Morgan’s Integrated Prime Brokerage and Custody Service – Prime-Custody Solutions*, https://www.jpmorgan.com/cm/BlobServer/PrimeCustody_Solutions.pdf?blobkey=id&blobnocache=true&blobwhere=1320555967068&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs (accessed 5 June 2018).
- 35 Grant Thornton, *Alternative Investment Fund Managers Directive (AIFMD) - The Depositary and Prime Broker (PB) Operating Model Dilemma*, http://www.grant-thornton.co.uk/Global/Publication_pdf/AIFMD.pdf (accessed 5 June 2018).
- 36 See ESMA, *supra* note 33, 390.
- 37 Art. 37 AIFM Law.
- 38 Global Fund Media, *AIFMD Depositary Models 2014 – Special Report*, http://www.hedgeweek.com/sites/default/files/GFM_AIFMD_14.pdf (accessed 5 June 2018).
- 39 B. Prew, *Six Months To Go For AIFMD - A review of developments in the depositary-lite market*, <http://www.thehedgefundjournal.com/node/9183> (accessed 5 June 2018).

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