

Clients & Friends Memo

EU to Require Insolvency Opinions in Relation to U.S. Sub-Custodians Under the EU AIFMD Regime

8 February 2019

Introduction

From April 2020 depositaries under the EU Alternative Investment Fund Managers Directive¹ (“**AIFMD**”) will need to obtain independent legal advice regarding the protections under U.S. insolvency law afforded to the assets under the control of U.S. sub-custodians who wish to act as delegates of the AIFMD depositary.

The AIFMD is the EU regime which regulates EU managers of unregulated funds. The background to the AIFMD’s depositary provisions and its delegation requirements in this context is outlined below.

Background – The AIFMD Depositary Requirement

The AIFMD regulates Alternative Investment Fund Managers (“**AIFMs**”) of Alternative Investment Funds (“**AIFs**”). One of the key elements of the AIFMD regime, which has applied since 2013, concerns depositaries. The depositary has a safekeeping custodian function and an oversight and cash monitoring function. For each AIF it manages, the AIFM must appoint a single depositary in accordance with the AIFMD.

Similar depositary requirements exist under the EU’s regime for Undertakings for Collective Investment in Transferable Securities (“**UCITS**”), the regime that concerns EU regulated funds.

Background – The Role of the Depositary under the AIFMD

The depositary is responsible for:

- (a) ensuring that investor money and cash belonging to the AIF (or to the AIFM acting on behalf of the AIF) is booked correctly on accounts opened in the name of the AIF (or in the name of the AIFM or depositary acting on behalf of the AIF);
- (b) the safe-keeping of the assets of the AIF; and

¹ Directive 2011/61/EU

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- (c) the verification of ownership of all other assets by the AIF (or the AIFM on behalf of the AIF).

It is possible for a depositary to delegate the safe-keeping of assets to a third party which, in turn, can sub-delegate that function. However, delegation and sub-delegation has to be objectively justified and is subject to strict requirements in relation to the suitability of the third party, and in relation to the due skill, care and diligence that the depositary should employ to select, appoint and review that third party. These delegation conditions are outlined below.

Delegation of Depositary Safe-Keeping Functions

The depositary may delegate its safe-keeping functions (but not its oversight functions) to third parties subject to specified conditions:

- (a) the tasks are not delegated with the intention of avoiding the requirements of the AIFMD;
- (b) the depositary can demonstrate that there is an objective reason for the delegation;
- (c) the depositary has exercised all due skill, care and diligence in the selection and the appointment of the third party; and
- (d) the depositary ensures that the third party:
 - (i) has the structures and the expertise that are adequate and proportionate to the nature and complexity of the assets entrusted to it;
 - (ii) is subject to effective prudential regulation, including minimum capital requirements, and supervision in the jurisdiction concerned;
 - (iii) segregates the assets of the depositary's clients from its own assets;
 - (iv) does not make use of the assets without the prior consent of the AIF or the AIFM; and
 - (v) complies with the general obligations on depositaries.

Due Diligence in the Selection of a Third Party Delegate

In order to fulfil the selection obligations, a depositary must apply an appropriate documented due diligence procedure to the selection and ongoing monitoring of the delegate. That procedure has to be reviewed regularly, at least annually, and made available upon request to competent authorities (i.e. the relevant EU national regulators). When selecting and appointing a third party to whom safe-keeping functions are delegated, a depositary must comply with various conditions.

These conditions include a requirement on the depositary to assess the regulatory and legal framework, including country risk, custody risk and the enforceability of the third party's contracts. That assessment is to enable the depositary to determine the potential implications of an insolvency of the third party for the assets and rights of the AIF. If a depositary becomes aware that the segregation of assets is not sufficient to ensure protection from insolvency because of the law of the country where the third party is located, it is to immediately inform the AIFM. The depositary must also:

- (a) assess whether the third party's practice, procedures and internal controls are adequate to ensure that the financial instruments of the AIF (or of the AIFM acting on behalf of the AIF) are subject to a high standard of care and protection;
- (b) assess whether the third party's financial strength and reputation are consistent with the tasks delegated; and
- (c) ensure that the third party has the operational and technological capabilities to perform the delegated custody tasks.

The Requirement for Independent Legal Advice in the Selection of a Third Party Delegate

In relation to exercising these due diligence obligations, new requirements are contained in Commission Delegated Regulation (EU) 2018/1618². These provisions will apply from 1 April 2020. The purpose of these new rules is to address issues caused by variances in national insolvency regimes across different non-EU countries. This is to ensure greater consistency in the method of segregation of assets held in custody by delegates in such "third countries".

These new provisions state that where a depositary delegates its custody functions to a third party located in a non-EU country, the depositary shall also ensure that it receives independent legal advice confirming that the applicable insolvency law recognises the following:

- (a) the segregation of the assets of the depositary's clients from the third party's own assets, from the assets of the third party's other clients, and from the assets held by the third party for the depositary's own account;
- (b) the assets of the depositary's AIF clients do not form part of the third party's estate in case of insolvency; and
- (c) the assets of the depositary's AIF clients are unavailable for distribution among, or realisation for the benefit of, creditors of the third party to whom custody functions have been delegated.

A legal opinion provided for a jurisdiction by a law firm for the benefit of several depositaries should be acceptable.

Parallel Requirements for UCITS Depositaries

Similar requirements for obtaining independent legal advice already apply to delegation by UCITS depositaries. These requirements have also been amended by a parallel regulation applying to UCITS that will also apply from 1 April 2020³.

² Amending Delegated Regulation (EU) No 231/2013

³ By Commission Delegated Regulation (EU) 2018/1618

The new AIFMD Delegate Provisions in the U.S. Context*The requirement for independent legal advice*

As noted above, where a depository delegates its custody functions to an entity located in a non-EU country such as the United States, the new due diligence provisions require the depository to obtain “independent legal advice” regarding the insolvency law protections in that country, especially having regard to the segregation of assets and the protection of assets in the event of insolvency.

Legally authorised custodians in the U.S.

In the U.S., the disposition of assets held in custody upon receivership of the custodian varies depending on the nature of the custodian and the nature of the assets. In the U.S., there is a wide variety of legally authorised custodians – FDIC-insured national and state-chartered banks, national and state-chartered trust companies, U.S. “state” and “federal” branches of non-U.S. banks, private banks, and SEC-registered broker-dealers – to name a few. Due to the fragmented nature of U.S. financial services law, each type of custodian typically has its own separate statutory regime governing receivership; these include the Federal Deposit Insurance Act, state banking law, the National Bank Act, the Dodd-Frank Act's Orderly Liquidation Authority, state trust company law, and the Securities Investor Protection Act (or “SIPA”) receivership regimes. Thus, the nature of the custodian can impact the receivership analysis and thus the opinion required to satisfy the EU requirements.

The protections afforded to securities held by a custodian

Generally speaking, in all these receivership regimes, securities held by a custodian – whether in certificated or in non-certificated form – are not swept into the receivership estate and are returned to the custodial customer, provided that the securities are properly recorded in the custodian's records as custodied assets. That being said, if the securities have been rehypothecated, this can sometimes complicate the legal analysis, if not the factual question of who actually owns the securities at the point of receivership.

The position of cash held by a custodian

Cash held by a custodian is often a different matter. In some of the U.S. insolvency regimes, unless properly structured as a so-called “special deposit” (i.e., a bailment of cash), a cash account can be viewed as a customer “deposit” with the custodian. This is classified as an unsecured liability of the custodian owed to the customer, and thus swept into the estate – leaving the customer with a claim against the receivership estate rather than an absolute right to the return of cash. The “priority” of a depositor's claim against the estate also varies; for example, depositors are given high priority in some regimes (in particular, the Federal Deposit Insurance Act) but are given relatively low priority in others.

Conclusion

The EU AIFMD regime allows the delegation by a depository of its safe-keeping functions to sub-custodians in non-EU countries such as the U.S., subject to specified conditions being met. New provisions will apply from 1 April 2020 focusing on the method of segregation of assets held in custody by delegates in non-EU countries. Where a depository performs such delegation, the new due diligence provisions will require the depository to obtain “independent legal advice”

regarding the insolvency law protections in that country, especially having regard to the segregation of assets and the protection of assets in the event of insolvency.

In the U.S. this requirement can involve complex issues regarding U.S. insolvency laws, especially given the fragmented nature of the laws governing U.S. custodians. Cadwalader Wickersham & Taft LLP can assist in fulfilling the AIFMD requirements by providing independent legal advice on the protections under the relevant U.S. insolvency laws.

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