

AIFMD and the Operational Implications for Depositaries in the Post-Madoff Era

thought

Regulation as a response to scandal

Bernie Madoff appeared to be a very successful fund manager until December 2008, when his giant Ponzi scheme¹ was uncovered. His fall led to many questions about the due care and diligence that fund managers were exercising on behalf of their investors. The combination of this scandal and the financial crisis has led to a raft of regulation globally.

The Alternative Investment Fund Managers Directive

Part of the European Commission's response to this situation is AIFMD – the Alternative Investment Fund Managers Directive. Level 2² of this Directive, published on December 19 2012, gave practical guidance on implementation. This Directive aims to protect investors in Non UCITS collective investment schemes by establishing rules for the management of this type of fund in the European Union.

Alternative funds will now require a depositary

Perhaps the most radical change introduced by AIFMD in the private equity arena is the mandatory appointment of a depositary for funds with Assets under Management (AUM) over €500m³. Among the key responsibilities of the depositary highlighted by the Directive are:

- Ownership verification and record keeping.
- Cash flow monitoring.
- Oversight duties.

In the following paragraphs we point to some of the practical implications of these new responsibilities to give more color to the discussion, rather than to provide an exhaustive analysis thereof.

Ownership verification

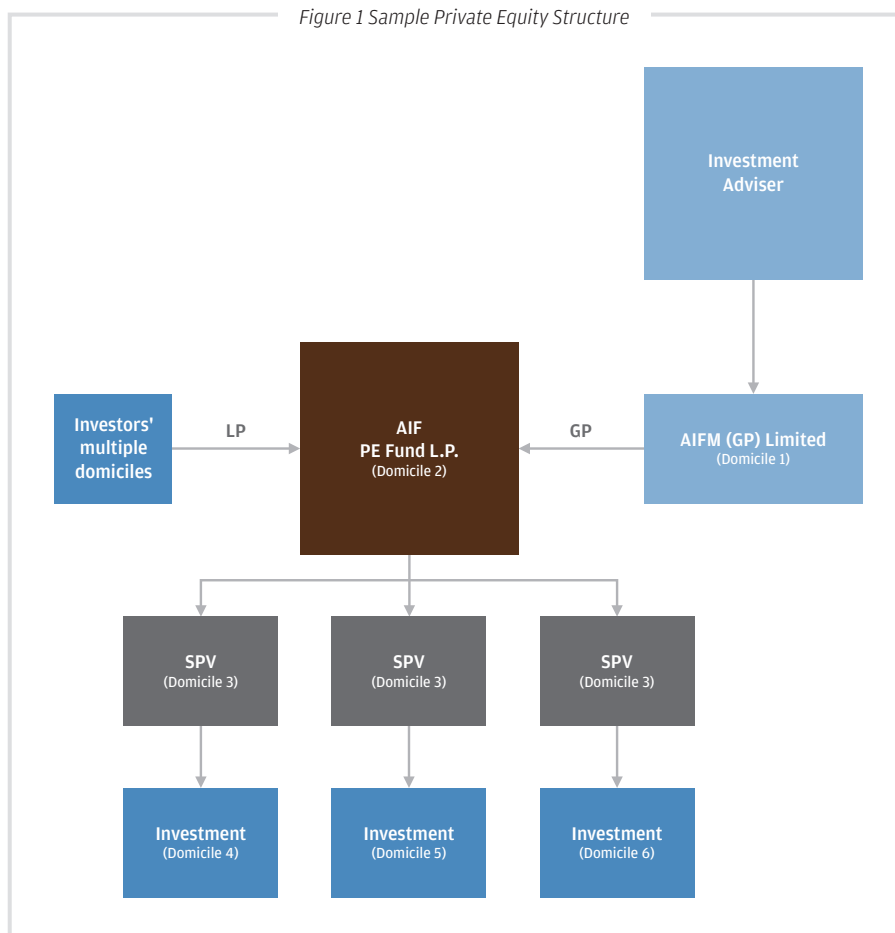
In accordance with AIFMD, the depositary needs to:

- Verify the ownership of the Alternative Investment Fund's (AIF's) assets.
- Reconcile its own records of the AIF's assets against the AIFM's assets.
- Have knowledge of the assignment, transfer or sale of any assets.

In many cases, an administrator⁴ is likely to hold these records on behalf of the AIFM. The interaction between the administrator and the depositary is therefore critical. As structures in the private equity industry tend to be complex, it can prove challenging to establish ownership of assets (investments) and be able to verify ownership during the life of the fund. One of the key complexities that needs to be accounted for is that private equity structures can involve numerous legal entities that are domiciled in several countries (see for example figure 1).

To be able to verify the existence of the assets, the depositary would potentially need to liaise with three levels of third parties each located in different countries. For example, the fund may be domiciled in the UK, investors throughout the EU, SPVs in the Channel Islands and investments may be global.

Figure 1 Sample Private Equity Structure



1. Fraudulent scheme where new investors' money paid for the old investors' principal using abnormal profits from investment activities that did not take place. This type of scheme was originally made famous by Charles Ponzi in the 1920s.

2. Level 2 of the Directive supplements Level 1 of the Directive with implementing measures.

3. This requirement applies provided that the AIFM manages only unleveraged AIFs that do not offer redemption rights for a five year period. This threshold lowers to €100m otherwise.

4. If the AIFM has outsourced administration to a third party.

Maintaining a network of agents that could verify the existence of the assets would then become expensive and potentially prohibitive for some less mature countries or regions.

Traditionally, depositary institutions have relied on trusted partners to provide key services; it is reasonable to expect that this will continue to be the case in this new competitive landscape. Depositaries will need to work with the fund manager to find the appropriate partner that can verify the ownership across these complex structures. Nevertheless, depositaries will retain the liability for carrying out this duty.

Cash flow monitoring

To be able to reconcile cash on a daily basis, depositaries will need to develop highly rigorous processes. The Directive requires that depositaries keep their own records of cash positions, check that those records are consistent with the AIFM's records and ensure payments are received and booked appropriately. In order to achieve this regulators expect that transaction information would be transmitted to the depositary by the close of business.

In an industry where reporting tends to happen in quarterly cycles, same day transmission would require a change in mindset as well as in systems and processes. This would require investment from the manager – increasingly we would see managers turning to an administrator to provide the necessary information.

By working together with these administrators, depositaries would be able to reconcile cash flows in the required timescale. Needless to say, all the parties involved (the AIFM, depositary and administrator) need to work closely to make these service levels achievable.

This close working relationship will also help the depositary to identify cash flows that are inconsistent⁵ with the AIF's operations on a daily basis.

Oversight duties

The AIFMD places an obligation on the depositary to oversee the fund's assets. This requires access to books and records on a timely basis. These procedures should take into account the specific characteristics of both investors and AIFs.

Furthermore, the valuation of these assets should be carried out independently of the portfolio management function of the AIFM. Depositaries need to ensure valuations are calculated in accordance with article 19 of the Directive⁶.

For private equity, this is mostly new grounds and the implementation of these new duties may carry extra risk. Depositaries therefore need to be clear on their scope of services and the assumptions they are using when defining service levels and pricing the business.

Conclusion

The new regulation will certainly bring more controls, but would it have exposed the Madoff fraud earlier? Certainly the requirement for a depositary together with the additional requirements in due diligence, cash flow reconciliation and management oversight should raise alarm bells at an earlier stage.

Daily reporting procedures coupled with depositary oversight could have introduced an extra layer of independent professional oversight. Finally, the requirement for asset verification could have prevented the Ponzi fraud as it may have revealed the non-existence of the assets in which the funds were supposedly invested.

Furthermore, the requirement to monitor cash flows may well have demonstrated that funds used to payout old investors came from the subscriptions of new investors rather than from the realizations of investments.

It is by no means clear if the benefits will outweigh the costs of implementation or how managers will adapt their processes to work together with depositaries, administrators and other third parties to meet these requirements. The good news is that we will surely find out.

5. e.g. If the AIF's strategy is to buy and hold securities until maturity, daily cash flows that show frequent trading would be inconsistent.

6. As well as national law and the incorporation articles of the AIF.

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