Depositary Decoded: What scope of depositary service do you need?

*If you're marketing your fund to European investors, you'll need to determine the scope of the depositary service you require to be compliant. **Eva Devine** and **Walter Varvara** explain how the services differ*

For U.S. fund managers planning to raise funds in Europe from European investors, they will, under certain circumstances, need the services of a depositary to be fully compliant with the Alternative Investment Fund Managers Directive (AIFMD).

In general, for U.S. managers, what has come to be termed 'depo lite' offers a more flexible version of traditional full scope depositary services. Which service a fund manager needs is determined by which part of the AIFMD governs the AIFM (Alternative Investment Fund Manager) or fund. The AIFMD is the primary piece of legislation governing private markets in the EU.

A good fund administrator will work alongside the depositary service, including flexible integration with client systems and bespoke compliance reporting. There are other considerations too, such as implementation challenges with operational setup potentially complex especially when it is necessary to coordinate with multiple administrators or service providers. There are also regulatory nuances to consider, for example some EU regulators, such as in Germany and Denmark, have 'gold-plated' the requirements to appoint a depositary, making them stricter than the baseline AIFMD.

You can read more of our insights into AIFMD here.

What is a full scope depositary service?

A full scope depositary is required under Article 21 of AIFMD for in-scope Alternative Investment Funds (AIFs). This is typically mandatory for EU-domiciled AIFs or those marketed under the AIFMD passport. Find out more about the AIFM passport here.

Key features include:

- Single depositary: One entity must be appointed per AIF. For example, an EU-domiciled fund managed by an EU-authorized AIFM must appoint a single depositary, to handle all depositary functions. This ensures accountability and avoids fragmentation of responsibilities.
- Geographic restrictions: For EU AIFs, it is the norm for the depositary to be established in the same EU country as the AIF. If a private equity fund is domiciled in Ireland, it must appoint an Irish-based depositary. This ensures alignment with local regulatory oversight and simplifies supervision by the national competent authority (NCA).
- Strict liability: The depositary is strictly liable for the loss of financial instruments held in custody. If a depositary loses securities due to negligence or intentional failure to properly fulfill its duties, it must reimburse the AIF for the loss. This liability incentivizes robust risk management and custody practices.
- Comprehensive oversight: Includes safekeeping of assets, cash flow monitoring, and compliance oversight. For a real estate AIF investing in European commercial properties, the depositary must, for example, verify ownership of property titles, and ensure asset valuations and investor redemptions comply with fund rules.
- Regulatory intensity: AIF depositaries must maintain detailed records, conduct regular reconciliations, and report to regulators. They often undergo audits and regulatory inspections to ensure compliance with AIFMD standards.

What is ‘depo lite’?

Depo lite applies under Article 36 or 42 of the AIFMD.

Article 36 permits EU member states to allow EU AIFMs to market non-EU AIFs into the EU without a passport.

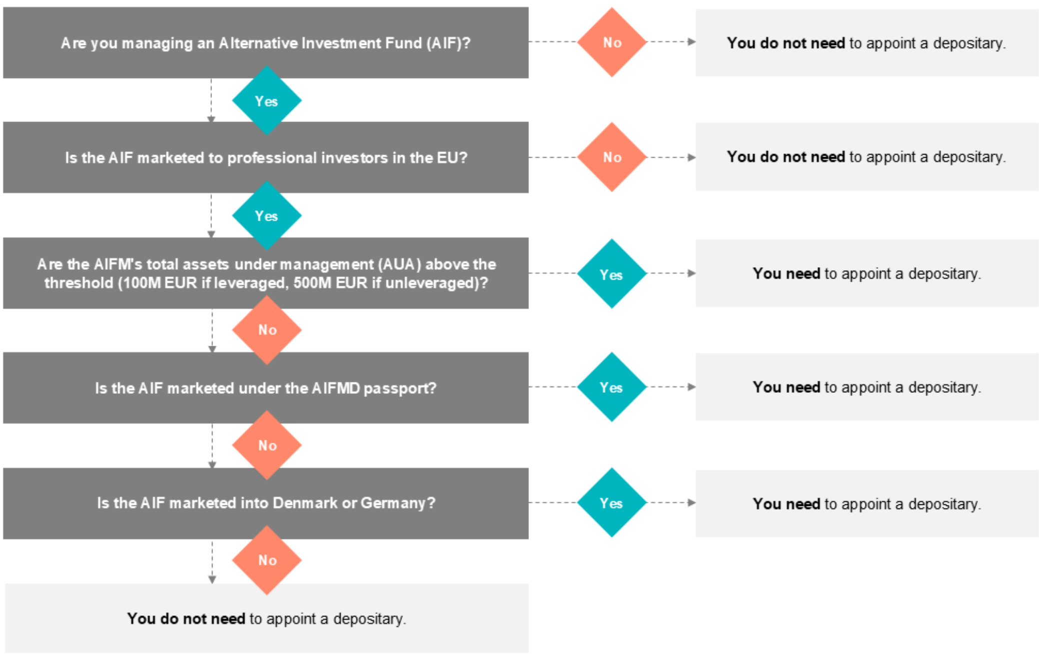
Article 42 of the AIFMD permits EU member states to allow non-EU AIFMs e.g. U.S. fund managers, to market EU and non-EU AIFs into the EU without a passport.

Key features include:

- Multiple providers allowed: More than one entity can perform the depositary functions. For example, a Cayman Islands hedge fund managed by a UK-based AIFM may appoint different services providers to perform different functions such as safekeeping, cash monitoring and oversight.
- No geographic restriction: The depositary can be based outside the AIF's domicile. For example, a Delaware-based private equity fund marketed to German institutional investors can appoint a UK, Irish or Luxembourg-based firm under the 'depo lite' regime.
- No strict liability: The depositary is not strictly liable for asset loss. If a provider fails to detect a misstatement in asset records, they are not automatically liable for the financial loss, unlike in the full depositary model. This makes some providers more willing to offer these services to non-EU funds.

How to determine your depositary needs

This simple decision tree illustrates how U.S. fund managers can determine their need for a depositary. This is the most likely scenario, but there are exceptions which can be facilitated on a case-by-case basis.



For U.S. managers, determining a fund's depositary requirements is but one part of a broader checklist, which includes understanding the best route to market, ensuring compliance with key regulation, and maintaining operational best practice. There is estimated to be $750 billion in U.S.-promoted private capital in European centers, and U.S. managers navigating Europe's complex and highly regulated environment need a third-party provider with comprehensive expertise and experience to streamline the journey. This guide equips U.S. managers with the tools to navigate Europe's complexities confidently and efficiently.

If you'd like more detailed information about your depositary needs or simply to discuss any of the considerations raised in this article, please contact us.