



Depository Duties in the Alternative Investment Funds Realm

One of the key players in the Alternative Investment Fund's industry sector is the depository. A depository is in essence the entity responsible for the safekeeping, cash monitoring and oversight of the AIF's assets. As the reader may appreciate, this is perhaps the most important service provider of an AIF as it operates as an independent third-party provider specifically appointed to ensure the investor's protection bearing also the responsibility to verify that the assets of the AIF are invested in accordance with the AIF's investment policy.

Pursuant to the Alternative Investment Funds Law 124(I)/2018 ("**AIF Law**"), the assets of the AIF must be entrusted for safekeeping to a depository which has its registered office: (i) in the Republic or (ii) in another member state of the European Union or (iii) in a third country provided that, in the last, certain specific requirements are fulfilled and that the Cyprus Securities and Exchange Commission ("**CySEC**") has approved its appointment.

Which entities are eligible to be appointed as depositaries of an AIF?

In order for an entity to be eligible to be appointed as depository of an AIF, it needs to be either:

- i) a credit institution; or
- ii) an investment firm; or
- iii) another category of institution which is subject to prudential regulation and supervision and which falls within the categories of institutions determined by EU member states as eligible to be appointed as depositaries. An obvious example of such entity eligible to act as a depository is an investment firm operating in accordance with the Directive 2014/65/EU (MiFID II).

In case of an AIF whose investment objective comprises of investing in assets which are not subject to custody, such an AIF may appoint as depositary an entity performing depositary functions within the context of its professional or business activities the performance of which is subject to professional registration, regulatory oversight or rules of professional conduct and can provide sufficient financial and professional guarantees verifying it will perform its depositary duties sufficiently and meet all obligations arising from such duties.

Is the appointment of a depositary obligatory for all AIFs?

Yes, irrespective of whether an AIF is internally managed or managed by an Alternative Investment Fund Manager (“AIFM”) in accordance with the provisions of the Alternative Fund Managers Law 56(I)/2013 (“AIFM Law”) or even in case of a Registered Alternative Investment Funds (RAIF) there is an overall obligation to appoint a depositary. The only exception to this rule is where the AIF is for Limited Number of Persons (“AIFLNP”).

Accordingly, an AIFLNP may not appoint a depositary in cases where:

- i) where its total assets do not exceed the amount of five million euros (€5.000.000) or its equivalent in another currency; in case the AIFLNP operates as an umbrella AIF, the total assets of all investment compartments must be considered; or
- ii) where its instruments of incorporation limit the number of unitholders to a maximum of five (5) natural persons; in case the AIFLNP operates as umbrella AIF, the number of all unitholders participating in all investment compartments must be considered;
- iii) where up to 10% of its total assets are subject to custody, the total number of investors are limited to 25 in accordance with its articles of association and the minimum subscription per investor is set at €500.000.

Are there any rules concerning the domicile of the depositary?

For Cyprus AIFs managed by an AIFM or for internally managed AIFs but which fall within the ambit of the AIFM Law it is mandatory for the depositary to be located in Cyprus.

For AIFs falling outside the ambit of the AIFM Law and for AIFLNPs the depositary can also be located in the European Union or in a third country provided that CySEC has signed with the competent authorities of the third country a Memorandum of Understanding and Exchange of Information and that the entity appointed to act as a depositary is subject to prudential regulation and supervision

including minimum capital requirements and the third country is not listed as a non-cooperative country by the FATF.

What are the duties of a depository?

As mentioned in the introductory paragraph of this article, a depository is responsible for safekeeping, cash monitoring and oversight of the AIF's assets.

More specifically, a depository is in charge of ensuring that all payments made by or on behalf of investors upon the subscription of units of an AIF have been received and that all cash received by the AIF, has been booked in cash accounts opened in the name of the AIF or on that of the AIFM acting on behalf of the AIF or in the name of the AIF.

For financial assets that can be held in custody the depository must:

- i) keep all financial instruments that can be registered in a financial instruments account opened in the books of the depository; and
- ii) maintain segregate accounts and accurate accounts for such financial assets so that they can be clearly identified as belonging to a particular AIF.

For other assets:

- i) the depository shall verify the ownership of the AIF of such assets and shall maintain a record of those assets;
- ii) for the verification mentioned in point i) it must request the appropriate information and where available obtain external evidence; and
- iii) always keep the records of such assets up-to-date and reconciled.

In addition to the above, the depository shall also ensure the following:

- i) that the sale, issue, re-purchase, redemption and cancellation of the units of the AIF are carried out in accordance with the instruments of incorporation of the AIF and in accordance with the principles of the applicable legislation;
- ii) the value of the units or shares of the AIF is calculated in accordance with the instruments of incorporation of the AIF and in accordance with the principles of the applicable legislation;
- iii) in cases where an AIFM is appointed, to carry out the transactions of the AIFM unless they conflict with the instruments of incorporation of the AIF or the applicable legislation;

- iv) ensure that the transactions which the depositary is instructed to perform are performed within the usual time limits; and
- v) ensure that the income of the AIF is applied in accordance with the applicable national law and the AIF rules or instruments of incorporation.

Can a depositary delegate its functions?

A depositary may only delegate to third parties the safekeeping functions and this is subject to the following considerations:

In relation to the third-party delegate, the depositary must ensure that at all times:

- i) the third party has the structure and the expertise to perform the safekeeping functions of the AIF;
- ii) that the third party is subject to effective prudential regulation, including minimum capital requirements and supervision and that the third party is subject to an external periodic audit;
- iii) that the third party segregates the assets of the depositary's clients from its own clients in a way that those assets can clearly be identified at any given time as belonging to the clients of the depositary;
- iv) the third party does not make use of the assets without the prior consent of the AIF or the AIFM acting on behalf of the AIF; and
- v) generally, is subject to the same safekeeping requirements as the depositary.

In relation to the overall decision of the depositary to delegate its functions:

- i) the functions must not be delegated with the intention to avoid the requirements of the AIF Law or the AIFM Law;
- ii) the depositary can demonstrate that there is an objective reason for the delegation; and
- iii) the depositary has exercised all due skill care and diligence in the selection of the appointment of the delegate and continuously examines the ability of the third-party delegate to perform its functions.

It is also important to note at this point that the third-party delegate can further sub-delegate some or all those functions delegated by the depositary to another party provided that the sub-delegation mirrors the requirements, obligations and responsibilities of the initial delegation.

What is the liability of the depositary?

A depositary must always act honestly, fairly, professionally, independently and in the interests of the AIF and the investors. As it clear from this proposition the depositary shall be liable to the AIF or to the investors of the AIF, for losses suffered by them as a result of the depositary's negligent or intentional failure to properly fulfil its obligations.

A claim can be brought against the depositary either by the unitholders of the AIF or through the external manager. It is important to note at this point, that in case the external manager of the AIF fails to initiate any claims against the depositary within three (3) months from the submission of a written demand by a unitholder to the external manager, the unitholder may initiate a claim against the depositary directly himself.

How is the depositary's liability affected by delegation arrangements?

The liability of the depositary is not affected by the delegation arrangements whether this includes a total or partial delegation of assets and the depositary remains jointly and severally liable with the third party for any loss caused by the third party. The only exception to this rule is in case of financial instruments held in custody by a third-party delegate. The delegate may be able to discharge itself of liability if it can prove that:

- i) all the requirements for delegation of its custody functions are met;
- ii) a written contract between the depositary and the third party expressly transfers the liability of the depositary to that third party and makes it possible for the AIF of the AIFM acting on behalf of the AIFM to make claim against third party for loss of financial instruments; and
- iii) a written contract between the depositary and the AIF or the AIFM acting on behalf of the AIF, expressly allows a discharge of the depositary's liability and establishes the objective reason to contract such a discharge.

We at Patrikios Pavlou & Associates LLC, are happy to advise in relation to any matters concerning the duties of a depositary of an AIF and to ensure the maximum legal and regulatory compliance of such entity.

Angelos Onisiforou | Senior Associate