Q Securities

THOUGHT LEADERSHIP

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Understanding the Depo Lite Regime for non-EU Fund Managers

- The depositary lite regime is essential for fund managers who wish to market non-EU investment funds.
- The AIFMD sets the general framework, while individual member states can adopt stricter requirements.
- Following Brexit and the growing expansion of AIFs from the US and Asia in the EU, we see a growing demand for depositary lite services.
- Depo lite is a less expensive alternative to carry out specific depositary functions, reducing compliance costs.

Non-EU fund managers looking to tap into the European investment market face the daunting challenge of navigating the complexities of the Alternative Investment Fund Managers (AIFM) Directive and private placement regulations. And then when you think you've finally figured it out, the depositary hurdle emerges.

Our team of experts has your back, providing invaluable guidance and turnkey solutions to help you conquer these obstacles and unlock the untapped potential of the EU investment landscape.

Passporting does not do the trick

The AIFMD Directive*, outlining rules that govern the marketing of non-EU and some EU investment funds, makes marketing of funds challenging for fund managers, particularly regarding the question of depositaries.

“The depositary is an institution responsible for ensuring the safekeeping of the fund’s assets, and appointing one is a *sine qua non* of marketing in the EU. Therefore, taking a closer look at the available legal options regarding depositary under AIFM Directive, somehow difficult to understand, often forgotten and sometimes overlooked, is a crucial first step to securing a foothold in the EU,” said Filip Suchta, Q Securities Country Head in Malta.

The EU passport, which was expected to facilitate the marketing of alternative investment funds (AIFs), has eventually not extended to non-EU countries deemed equivalent to European regulations regarding investor protection and systemic risk. Additionally, Brexit has increased the demand for depositary-lite services for AIFs from the US and Asia in the EU.

The depositary lite regime applies when an EU AIFM wishes to distribute non-EU AIF in the EU, a non-EU AIFM wishes to distribute EU AIF in the EU, or a non-EU AIFM wishes to distribute non-EU AIF in the EU. The following are two examples of such cases:

> (1) If a Luxembourg AIFM distributes UK AIF in Luxembourg, it must comply with the Luxembourg private placement regime based on AIFM Directive.
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> (2) If a USA AIFM distributes Luxembourg AIF or Cayman Islands AIF in Luxembourg, Ireland, and Germany, it must comply with the Luxembourg, Ireland, and Germany private placement regimes based on AIFM Directive.

The depositary lite regime is governed by Articles 36 and 42 of the AIFMD and has practical implications that are somewhat challenging to understand, particularly as the AIFMD sets the general framework, while individual member states can adopt stricter requirements. For instance, Germany and Denmark, while Luxembourg and Ireland have not. In practice, if a non-EU AIFM wants to market AIFs, for example, in Luxembourg and Germany, it must comply with the depo lite regime adopted in Germany – a country with more strict requirements.

The good news is that, in principle, the depositary lite regime imposes fewer obligations than the full depositary. A fund manager, however, is still required to comply with the regulations of the private placement regime of each member state. With Brexit and the growing expansion of AIFs from the US and Asia in the EU, the demand for depositary lite services has increased and the trend is likely to continue.

The depo lite regime is an alternative to the full depositary regime, with similar obligations but without the strict liability for loss of financial instruments. Moreover, under the depo lite regime, the depositary must only carry out functions relevant to an AIF's assets. This means depo lite services are less pricey, reducing compliance costs for fund managers. Additionally, the reduced scope of services can lower operational costs.

“The benefit might be particularly welcome by smaller AIFs, which may not have the resources to comply with the full depositary regime,” Filip Suchta said.

However, the depo lite regime has its limitations. For instance, it is unsuitable for AIFs that invest in complex assets or those with a high level of leverage. In such cases, a full depositary is necessary to ensure adequate investor protection. Moreover, the depo lite regime is only recognised in some EU member states, and thus, it may not be available in certain jurisdictions.

Choosing wisely

There’s no way around the depositary obligation to comply with the AIFM Directive, and fund managers must appoint one to oversee an AIF's assets. The depositary can be a bank or another financial institution, like Q Securities, authorised to act as a depositary per the directive.

"Finding the right depo lite service provider these days is easier than a few years ago, but that does not mean it is a simple task. Fund managers still face some market challenges in this regard if they are not part of big capital groups," said Filip Suchta.

While cash flow monitoring and safekeeping duties generally do not cause practical problems, the oversight function may generate some risk. Managers naturally prefer an EU-based depositary with sufficient knowledge and experience, covering different jurisdictions and being abreast of the constantly changing regulatory environment.

The most sought-for depositary-lite providers are those who tailor their services to the nature of AIFs, adjust procedures, implement relevant systems and infrastructure to ensure the proper performance of the depositary-lite functions provided.

To keep costs at bay, the depositary function is often split among several entities by mixing models with prime brokers, administrators etc. while introducing procedures and ensuring no conflict of interest or duplication of duties.

DIFFERENCES	DEPO-LITE	FULL DEPOSITARY
Strict liability for loss of financial instruments	No	Yes
Single entity required	No	Yes
Needs to be located in the fund jurisdiction	No	Yes
Delegation and outsourcing restricted	No	Yes

* The Alternative Investment Fund Managers (AIFM) Directive is a regulatory framework developed by the European Union to govern the management and marketing of alternative investment funds (AIFs) and aims to promote investor protection, increase transparency, and establish a level playing field for fund managers. One of its key provisions is the depositary regime, established to ensure that AIFs are managed in the best interest of investors.

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