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NEW AIFMD REQUIREMENTS APPLICABLE TO THE DELEGATION OF SAFEKEEPING FUNCTIONS AND THEIR IMPACT ON THE APPOINTMENT OF US PRIME BROKERS[1]

On 29 May 2018, the EU Commission published a proposal for a Commission Delegated Regulation amending Delegated Regulation (EU) N° 231/2013 as regards safe-keeping duties of depositaries (respectively the "Proposed Regulation" and the "Level 2 Regulation"). Amongst the changes tabled by the EU Commission, it is proposed to amend Article 99 of the Level 2 Regulation to introduce new obligations for depositaries, which delegate the safekeeping of assets to third parties located outside the EU.

Similar to what is provided under the UCITS Directive[2], the depositary of an Alternative Investment Fund (AIF) falling within the scope of the AIFMD[3] shall be required to obtain legal advice from independent parties on the insolvency laws of the third country, and in particular that such insolvency laws recognise that the assets of the depositary's AIF clients do not form part of the third party's estate in the event of insolvency, and that such assets are unavailable for distribution among, or realisation for the benefit of, creditors of the third party to whom safekeeping functions have been delegated.

Analysing foreign legal systems and comparing them to domestic legal concepts is not an easy task. It becomes even more complex when the third party custodian provides services and is granted rights that go beyond the traditional custody services provided by a correspondent bank.

Such complexities arise in particular for AIFs following a hedge fund strategy (the Funds) and that need to appoint a Prime Broker (PB). PBs will usually be required to hold assets of the Fund in custody and be authorised to re-use (rehypothecate) these assets. Depositaries of such Funds will typically be required to delegate their safekeeping functions to the PBs subject to Article 21(11) of the AIFMD and Articles 98 and 99 of the Level 2 Regulation. In addition to the existing requirements, depositaries will, in the future, be required to assess insolvency laws applicable to the PBs and ensure that the new proposed requirements of Article 99 will be met.

Rehypothecation is the practice whereby PBs use the customer securities they hold to secure financing from third parties that is then used by PBs to grant margin loans to their customers. The practice for PBs (consistent with US laws and regulations) is to rehypothecate client securities representing up to 140% of the aggregate amount of all margin loans granted by a PB to its client (the "debit balance").

Rehypothecation has on occasion been interpreted as increasing the counterparty risk that a Fund has towards its US PB, thus putting the Fund at greater risk in case of insolvency of the PB. This misinterpretation has been discussed thoroughly with different stakeholders and more recently with respect to a Luxembourg non-supervised AIF managed by a Luxembourg AIFM, involving the

1. All US rules applicable to PBs that are mentioned in this paper are a summary of discussions the author had with US Counsel and are mentioned only for informative purposes. Readers should not rely on the information set out herein as legal advice and should consult with counsel as needed.
2. Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended by Directive 2014/91/EU (...) as regards depositary functions, remuneration policies and sanctions.
3. Directive 2011/61/EU on alternative investment fund managers, as amended.

Luxembourg regulator. The latter confirmed (in a nutshell) that setting the rehypothecation level was the responsibility of the AIFM, and not something for the regulator to object to nor opine on, stressing that the AIFM is required to monitor appropriately all risks to which the Fund may be exposed. This would include counterparty risk (amongst others).

This overall positive assessment by the stakeholders and the regulator were driven inter alia by an analysis of the US rules which are designed to ensure that customers of US PBs should be able to retrieve their assets (i.e. cash and securities) in case of insolvency of the PB, notwithstanding rehypothecation having taken place. Although this assessment was conducted prior to the publication of the Proposed Regulation, it may be helpful in the future to assess compliance with some of the new requirements of Article 99 of the Level 2 Regulation with respect to US PBs and applicable US insolvency rules.

According to US rules, PBs are prevented from using customer assets to finance their own proprietary business, which is a first but essential point in ensuring that Fund assets will not be available to satisfy own creditors of the PB in case of insolvency. Moreover, in the event of insolvency of a PB, liabilities of the PB towards its customer and vice-versa would be compensated, meaning that the customer shall not be at risk of suffering a loss that would be higher than the value of the rehypothecated assets given that it will be entitled to retain the amount of the margin loan granted to it: the customer always has a "net equity claim" towards its PBs equal to the market value of the cash and securities in the customer's account with the PB less its debit balance (the "net equity claim").

In a scenario where a PB would agree to limit its rehypothecation rights to securities representing 100% of the margin loans that are granted to the customer, it is easy to conclude that the customer's counterparty risk towards the securities held by the PB as margin is entirely mitigated by the corresponding amount of cash that it has received from the PB and that it is secured by the corresponding amount of securities held by the PB to secure that loan. According to the net equity claim, if the PB cannot return the securities to the customer, the latter will keep the cash.

Raising PBs' rehypothecation rights up to the regulatory limit of 140% of the customer's debit balance would not, however, increase risks for the customer. This is because of the specific protections that US insolvency rules applicable to PBs grant to customers in case of the insolvency of a PB, including with respect to the 40% rehypothecated securities exceeding the value of the debit balance.

As indicated above, a PB can only rehypothecate client securities for the purpose of financing margin loans to clients and not to use in its own business. The PB must maintain "possession or control" of customer fully-paid securities held with the PB including "excess margin securities" (those with a value that exceeds 140% of the client's debit balance). Control means that the securities are located in an account in the name of the PB at a clearing corporation, depository or bank, free of any lien or security interest and for the exclusive benefit of the PB's clients.

In addition, as required by applicable rules of the Securities and Exchange Commission ("SEC") and in particular Rule 15c3-3 (the "SEC Rules"), each PB is required by US law to deposit cash or specified securities into a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (the "reserve account") each time a client maintains a free cash balance with a PB. These amounts are segregated from the PB's own assets for the exclusive benefit of the PB's clients, and are not available to satisfy the PB's own creditors in case of insolvency. The reserve account must be held with a separate US financial institution separate from any other bank accounts of the PB held with that financial institution. Cash and securities in the reserve account should be held by the bank for the exclusive benefit of the customers of the PB, separate from any other accounts maintained with the bank by the PB. None of the cash and specified securities in the account may be used as collateral for a loan to the PB by the bank and should not be subject to any right, charge, security interest, lien or claim of any kind in favour of the bank.

The PB is also required to account for the rehypothecated securities exceeding 100% of the client's debit balance (e.g., the additional 40%) in the calculation of the amount to be deposited into the reserve account and segregated from the PB's own holdings, meaning that this client's rehypothecated securities are protected in the same manner as client-free cash balances, as required by the SEC Rules mentioned above. The value of those securities is

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daily marked to market, meaning that the value to be deposited in the reserve account must constantly match the value of the excess 40% securities that have been rehypothecated.

Accordingly, the reserve account and the possession and control requirement work together to provide that assets held by the PBs in the segregated client accounts are at least equal to the clients' net equity claims. Rehypothecation should therefore not be a factor in determining a client's net equity claim or its recovery in the event of a PB bankruptcy.

As an example, client deposits $100 into its client account at the PB and borrows (margin loan) $100 from the PB to purchase securities with a total market value of $200. The PB is permitted to rehypothecate $140 (140% of the $100 margin loan). When the PB rehypothecates or uses such client securities, the PB is required to deposit $40 into the reserve account for the benefit of the client. The net equity of the customer of $100 should be fully protected under the US laws and regulations as follows: the excess margin securities ($60) are held in the segregated customer securities account and the $40 of the proceeds from the rehypothecated securities are held in the reserve account.

Cash account clients have no priority over margin customers: if their net equity claims vis-à-vis the PB are the same, they will both get the same amount back from liquidation. Clients whose securities have been rehypothecated should stand in the same priority as customers whose securities have not been rehypothecated. In the event of insolvency of the PB, if it is not possible to retrieve the actual securities that were deposited by the client and rehypothecated by the PB, securities of an identical type or the full value of those securities will be returned to the client. The client should also retrieve the full amount of cash that was held with the PB. The client should therefore be protected for the entire amount (in value) of its cash and (rehypothecated) securities.

In terms of reporting, PBs should give reports to the depositary informing it of the customer's securities held with the PB that are available for rehypotecation, notwithstanding the application of the US regulatory limit of 140%. In addition to the foregoing, the SEC Rules and the fact that PBs are required to comply with these rules at all times, should provide sufficient comfort to the depositaries that rehypothecated securities exceeding 100% of the client's debit balance (i.e. the additional 40% maximum) are duly accounted for on the reserve account.

Allowing PBs to rehypothecate client securities up to the US regulatory limit of 140%, rather than 100%, should not increase the risk of loss for the customer, including in case of insolvency of the PB. Accordingly, depositaries that will be subject to revised Article 99 of the Level 2 Regulation (as amended by the Proposed Regulation) should be able to obtain legal advice and confirmation from US counsel that US insolvency rules applicable to US PBs will recognise the new requirements thereof.