



association of the
luxembourg fund industry

REAL ESTATE INVESTMENT FUNDS: DEPOSITARY ASPECTS

Guidance note for the asset management industry

Table of contents

- Introduction • 4
- Disclaimer • 4
- Executive summary • 4

CHAPTER I: LEGAL AND REGULATORY BACKGROUND • 5

- 1. What are the depositaries fiduciary duties? • 6
- 2. What are the different parties involved in a real estate fund? • 6
- 3. What is a Depositary of real estate funds? • 6
- 4. Who can act as Depositary of an AIF investing in Real Estate? • 7
- 5. What are the depositary duties on EU Investment Structures • 7
- 6. What are the depositary duties on Non-EU investment structures? • 8
- 7. How is the depositary appointed and removed? • 8
- 8. What is the liability of a Depositary? • 8
- 9. What is the legal framework covering their engagement? • 8
 - 9.1 Cash Monitoring • 8
 - 9.2 Safekeeping • 9
 - 9.2.1 What is meant by depositaries safekeeping duties apply on a look through basis? • 10
 - 9.2.2 Are holdings in Collective Investment Undertakings to be held in custody (Fund of Funds)? • 10
 - 9.2.3 Does the look through requirement applies for investments that are themselves save-kept by another depositary? • 10
 - 9.3 Oversight duties • 10
- 10. What are the obligations of a depositary? • 10
- 11. How should a depositary monitor investment guidelines? • 11
- 12. What are the limitations of the depositary's work (force majeure, serious fraud, etc.)? • 11
- 13. What are the responsibilities and rights of a depositary in conducting its supervisory function? • 12
 - 13.1 The knowledge of the depositary • 12
 - 13.3 The depositary's assessment of the availability of assets • 12
 - 13.3 The means of a depositary • 13
 - 13.4 The independence of a depositary • 13

CHAPTER II: WHAT SHOULD A DEPOSITARY DO IN PRACTICE? • 14

- 1. Introduction • 15
 - 2. Fund Set-up (Planning) • 15
 - 3. Understanding the ownership structure • 15
 - 4. Real Estate acquisition • 16
 - 4.1 Typical steps in Real Estate acquisition • 16
 - 5. What are the types of evidence typically requested by a depositary related to an acquisition? • 17
 - 6. How should the depositary process the payment required for an acquisition? • 17
 - 7. What action is required after payment of the acquisition price? • 18
 - 8. Holding • 18
 - 9. Ongoing supervision • 18
 - 10. Real estate disposal • 19
 - 10.1 Typical steps in Real Estate disposal • 19
 - 10.2 What are the recommended transaction checks for a disposal? • 19
 - 10.3 How does the depositary supervise the disposal? • 20
 - 10.4 What actions are required after the completion of the disposal? • 20
 - 11. Confirmation and reports • 20
-

Disclaimer

Please note that ALFI, being the representative body of the Luxembourg investment fund community, is a non-profit organisation pursuant to Luxembourg law and does not provide legal advice. Please note that these guidelines have not been validated by any regulator and serve only for information purposes.

This document is published by ALFI as generic guidance and while reasonable care has been taken in compiling the information, ALFI does not accept any liability for the guidelines and does not guarantee in any way that they will be appropriate

to specific circumstances of the reader. Readers are advised to seek appropriate professional advice for setting up their REIF.

Readers should seek the advice of qualified professionals before making any decision as to the most appropriate Luxembourg real estate vehicle for their needs.

Executive summary

This guidance note provides an overview of the application of the Alternative Investment Fund Managers Directive (AIFMD)¹ for depositories of alternative investments funds (AIF) within the meaning of the Law of 12 July 2013 on Alternative Investment Fund Managers (AIFM Law)².

Furthermore, this document takes the form of answers to frequently asked questions, primarily in respect of the role and activity of a depository of an AIF, applicable to regulated and unregulated Luxembourg real estate investment funds (REIFs) in the form of undertakings for collective investment (UCI) governed by Part II of the Law of 17 December 2010 (UCI Law/Part II Law)³, SIFs governed by the law of 13 February 2007 (SIF Law), SICARs governed by the law of 15 June 2004 (SICAR Law), the RAIF governed by the Law of 23 July 2016 (RAIF Law) and other Alternative Investment Funds that are obliged to appoint a depository in accordance with the AIFM Law.

The guidance note should be read in conjunction with the ALFI brochure on Luxembourg Real Estate Investment Funds⁴, which provides a general background on legal and taxation aspects of regulated and unregulated real estate vehicles domiciled in the Grand Duchy of Luxembourg.

The answers to the frequently asked questions do not constitute regulation and should only be considered as guidance on common practice. In addition, answers are directed at regulated (directly or indirectly via the AIFM) Luxembourg REIFs.

Chapter I of this paper provides a high level legal and regulatory background with questions on the roles of a Depository.

Chapter II of this paper lays out more practical examples.

This document reflects the legal and regulatory situation as at January 2019. Further details on depository guidelines regarding “other assets”, those assets not to be held in custody, are covered in publications by the ALFI ABBL Depository Bank Forum and from the CSSF circular 18/697.

1 Alternative Investment Fund Managers Directive, Directive 2011/61/EU of the EP and of the Council of 8 June 2011

2 [www.alfi.lu/sites/alfi.lu/files/files/Legal and technical/AIF-English.pdf](http://www.alfi.lu/sites/alfi.lu/files/files/Legal%20and%20technical/AIF-English.pdf)

3 [www.alfi.lu/sites/alfi.lu/files/files/Legal and technical/UCITS-English.pdf](http://www.alfi.lu/sites/alfi.lu/files/files/Legal%20and%20technical/UCITS-English.pdf)

4 <http://www.alfi.lu/sites/alfi.lu/files/Luxembourg-Real-Estate-final.pdf>

Legal and regulatory background

4. Who can act as Depositary of an AIF investing in Real Estate?

The AIFMD has a very broad application and, therefore recognises the need to broaden the scope of the parties that may act as a depositary in a real estate context. They may include any of the following:

- An authorised credit institution with its registered office in the EEA;
- A MIFID-authorised investment firm (limited scope in respect of “other assets” only);
- another institution subject to prudential regulation and ongoing supervision and which is eligible to act as depositary of a UCITS⁷; and
- In Luxembourg and other electing states, a regulated entity which carries out depositary functions as part of its professional or business activities.

In relation to AIFs which have no redemption rights exercisable during the period of five years from the date of the initial investments; and which generally do not invest in financial instruments; or invest in issuers or non-listed companies in order to potentially acquire control over such companies, the depositary may be an entity which carries out depositary functions as part of its professional or business activities.

In all cases, the depositary is subject to the supervision of the Luxembourg regulator, *Commission de Surveillance du Secteur Financier* (CSSF).

Under the AIFMD, the depositary of an EU AIF must be established in the domicile of the AIF. For Non-EU AIF, the depositary must be established either where the AIF is established or in the home country of the AIFM.

5. What are the depositary duties on EU Investment Structures?⁸

AIFM	SIF	SICAR	UCI Part II	RAIF	SOPARFI
Status	CSSF regulated	CSSF regulated	Must be a credit institution		unregulated
Out of scope AIF	Only safe-keeping* with no look through	Only safe-keeping* with no look through	N/A (UCI always AIF; Art 88-1 of the UCI Law)	N/A, per definition AIF	No depositary
AIF with registered AIFM*	Only safe-keeping*	Only safe-keeping*	Only safe-keeping*	Not possible	Only safe-keeping*
Status	Single depositary established in Luxembourg for:				
	<ul style="list-style-type: none"> - Cash flow monitoring - Safekeeping - Oversight of the proper operation of the AIF 				

*as meant under Chapter 5. Part I CSSF Circular 18/697

⁷ Undertakings for Collective Investments in Transferable Securities (law of 17 December 2010)

⁸ AIFM managing AIF with a portfolio that is not exceeding EUR 100 mio in the case the portfolio was acquired through leverage or not exceeding EUR 500 mio in the case of unleveraged acquisition are exempted from the application of the AIFM Law, expect that they need to be registered rather than authorised by the CSSF

6. What are the depositary duties on Non-EU investment structures?

Only EU AIFM managing EU AIF are subject to the full depositary regime, whereby a single depositary is required to perform the three core depositary duties. Authorised AIFM established in Luxembourg or any other EU Member State (EU AIFM) who are marketing Non-EU AIF in Luxembourg are not obliged to appoint one single depositary but can appoint different entities to fulfil the three depositary duties (Depo Lite).

7. How is the depositary appointed and removed?

Depositaries are in principle appointed and removed by the governing body of the AIF (being either the AIFM or the Management of the AIF), subject to the approval of the CSSF. The appointment is agreed in a written contract that must set out the extensive particulars listed in article 83 of the AIFMD and the Delegated Regulation. These particulars are intended to establish a clear framework that enables the depositary to fulfil its obligations. The contract should be adapted to each specific type of fund.

Depositaries can be removed in specific circumstances at the determination of the regulator, by virtue of bankruptcy or by virtue of a provision in the fund documents, such as termination clauses. In addition, a depositary has the right to resign provided that it continues to act in the best interests of investors until a replacement depositary has been appointed.

The service provider providing Depo-Lite (see meaning above) services do not need to be located in the same country than the AIF.

8. What is the liability of a Depositary?

There are two levels of liability of a depositary. For assets that must be held in custody (financial instrument) a strict liability applies, meaning that in the case of loss of these assets the depositary is obliged to return financial instruments of identical type or the corresponding amount to the AIF or the AIFM acting on behalf of the AIF without undue delay. The depositary will not be liable for the loss of financial instrument in the case of "external event beyond its reasonable control"

or in the case of delegation of the custody when specific strict delegation requirements have been applied.

For other assets, the depositary is liable for any other losses suffered by the AIF as a result of negligent or intentional failure to properly fulfil its obligations.

9. What is the legal framework covering their engagement?

The UCI Law, the SICAR Law, the SIF Law, and the RAIF Law require the appointment of a depositary. Furthermore, for AIF not falling under the rules of any of the beforehand mentioned specific fund laws a depositary has to be appointed in the case the AIFM is authorised by the CSSF. For Self-managed AIF or AIF that are managed by an AIFM that only need to be registered (AuM below EUR 100 mio resp. EUR 500 mio if not leveraged) do not need a depositary.

9.1 Cash Monitoring

The depositary shall ensure effective and proper monitoring of the fund's cash positions and flows and should in particular check that all payments made by or on behalf of investors upon the subscription or redemption of units or shares in a fund have been properly booked in an account with a qualifying institution and in an account opened in the name of the fund or in the name of the AIFM/or Depositary acting in its name.

To achieve this, the depositary must have access to all information regarding the fund's cash accounts. It should undertake cash flow reconciliations on a daily basis or otherwise when movements occur within the fund, and immediately raise any discrepancies with the manager, investors or the competent authorities (if appropriate).

Cash flow monitoring cannot be delegated by the depositary. The depositary may choose to rely on material tasks executed by a third party (e.g. administrator reconciliations), provided that the depositary obtains all information it needs to comply with its own cash monitoring obligation and has performed an adequate due diligence of the reconciliation processes performed by the third party.

Cash is not a custody asset and cash monitoring should not be confused with safekeeping.

The cash monitoring duty is limited to the accounts in the name of fund itself, and no look-through obligation applies. Article 86 of the Level 2 AIFM Regulation solely requires effective and proper monitoring of cash accounts opened in the name of the AIF.

9.2 Safekeeping

The AIFMD/AIFM Law recognises two different safekeeping duties depending on the nature of the assets:

- A classic custody obligation for financial instruments that are held in custody; and
- A title verification and record keeping obligation for all other assets.

Assets subject to a custody regime include only those financial instruments that are capable of being registered in a special account in the depositary book, or which are physically delivered to it to be held in custody.

Assets that are considered as financial instruments, and therefore custodial assets, include:

- Electronically settled securities in a clearing system, such as listed equities and bonds;
- Bearer securities; and
- Fund units, (in the case, units are not only directly registered in the name of the AIF or the AIFM acting on behalf of the AIF).

Other assets such as private registered shares, loans, partnership interests or real assets are not considered as being held in custody.

REIF do not generally invest in financial instruments and, therefore, no custody obligation usually arises on the part of the depositary. While it is possible that financial instruments may be held within a fund portfolio from time-to-time as a result of an investment this will be relatively rare and these financial instruments are likely to be held by a holding company for structural purposes.

Where the fund holds financial instruments, a non-financial institution depositary will need to appoint a custodian in accordance with specific delegation provisions in the AIFMD/AIFM Law. The depositary will be responsible for ensuring that the custodian is appropriately qualified to undertake the custody duties delegated and that it fulfils its obligations on an ongoing basis. The depositary will be strictly liable for any loss by the custodian of financial instruments unless this liability is contractually transferred to the custodian in accordance with the AIFMD/AIFM Law and the AIFMD Level 2 AIFM Regulation.

If the depositary seeks to exclude liability this shall only be permitted if the depositary can demonstrate objective reasons to contract such discharge. Furthermore the AIFM needs to give prior approval to the discharge and this should in principle be disclosed to investors in the fund's documentation and agreed upon in a written agreement with the custodian.

The safekeeping duty of the depositary of a REIF with regard to non-financial instruments assets is very different to the custody of financial instruments. It comprises establishing and maintaining records, verifying the ownership of investments (based on information supplied generally by the AIFM). This requires:

- Ensuring that the depositary has access to all relevant information it needs to verify ownership of investments and maintaining registers of these to be able to provide up-to-date reconciliations;
- Establishing escalation procedures for situations where an anomaly is detected including notification of the manager, investors or the competent authorities (as appropriate); and
- Ensuring that safeguards exist to prevent investments being assigned, transferred, exchanged or delivered without the depositary's awareness.

These duties should not be understood as simply "collecting paper" if they are to be meaningful, but working alongside the manager and its advisers on a real time basis as investments are made to ensure that all reasonable care is taken and

appropriate safeguards are put in place. Depositaries are not investment professionals or legal experts, and may choose to rely on the work of other experts and properly authorised decisions of the manager.

Generally, the Depositary should keep its own asset register and independently reconcile this register with external resources. Periodic ownership verification should be implemented. Given the nature of the safekeeping duties in a Real Estate context, the depositary should not need to appoint a delegate in the jurisdiction of the target investment in most cases. This should only arise in the context of financial instruments.

9.2.1 What is meant by depositaries safekeeping duties apply on a look through basis?

In cases where a REIF holds an investment through a series of intermediate holding and property companies, the depositary's safe-keeping duties apply⁹ on a look-through basis to the underlying investments.

9.2.2 Are holdings in Collective Investment Undertakings to be held in custody (Fund of Funds)?

Generally, shares in funds have to be held in custody unless these shares are only registered with the issuer itself or its agent in the name of the AIF or the AIFM acting on behalf of the AIF.

9.2.3 Does the look through requirement apply for investments that are themselves safekept by another depositary?

The look through requirement does not apply to Fund of Funds or Master-Feeder structures in the case the underlying funds have a depositary with duties that are comparable with the AIFMD requirements.

9.3 Oversight duties

The depositary is responsible for devising oversight procedures to ensure the proper management of the AIF.

In accordance with Art. 19 (9) of the AIFM Law, the depositary must:

- Ensure that the sale, issue, re-purchase, redemption and cancellation of units or shares of the AIF are carried out in accordance with the applicable national law and the AIF management regulations* or instruments of incorporation;
- Ensure that the value of the units or shares of the AIF is calculated in accordance with the applicable national law, the AIF management regulations* or instruments of incorporation and the procedures laid down in Article 19 of Directive 2011/61/EU (valuation by the AIFM);
- Carry out the instructions of the AIFM, unless they conflict with the applicable national law or the AIF management regulations* or instruments of incorporation;
- Ensure that in transactions involving the AIF's assets any consideration is remitted to the AIF within the usual time limits;
- Ensure that an AIF's income is applied in accordance with the applicable national law and the AIF management regulations* or instruments of incorporation.

These oversight procedures should be devised following a risk assessment of the AIF and the AIFM, should be proportionate and should consist of ex post controls and checks of the administrator or the manager. Oversight is an ongoing obligation and any discrepancies must be escalated to the manager, investors or the competent authority (as appropriate).

To discharge this oversight duty, the manager should provide the depositary with all relevant information relating to the fund and full access to all records.

10. What are the obligations of a depositary?

The AIFMD/AIFM Law is intended to ensure a high standard of investor protection across the EEA. One of the methods by which this is achieved is the introduction of a depositary requirement for all AIFs managed by qualifying AIFMs. The depositary is responsible for overseeing the proper management of AIFs.

⁹ AIFM CDR Article 90 (5).

The depositary function consists of three key duties:

- Monitoring all cash flows passing through the AIF and, in particular, ensuring that all monies received for the subscription and redemption of units or shares is properly bookkept (Cash Monitoring);
- The safe-keeping of fund assets, whether through custody or through more general verification of ownership and record keeping (Safekeeping); and
- It must oversee the proper operation of the AIF by implementing a number of controls and checks (Oversight Duties).¹⁰

11. How should a depositary monitor investment guidelines?

In accordance to Art. 19 (9) of the AIFM Law (Art. 21 of the AIFMD) the depositary shall "...carry out the instructions of the AIFM, unless they conflict with the applicable national law or the AIF management regulations or instruments of incorporation;...".

The overall responsibility does not fundamentally differ from those applicable to traditional securities funds, i.e. the depositary will have to monitor the compliance of transactions involving the assets of the fund with the set of investment restrictions laid down in the fund documentation ex post. The specifics of real estate funds will generate particular behaviors and processes in circumstances such as property acquisitions, developments or disposals.

The specifics of the fund, notably through the prospectus or PPM, may require particular procedures to be established in certain circumstances (e.g. creation, intervention and interaction of internal bodies, such as an Investment Committee and/or Unitholders Advisory Committee).

Monitoring of fund operations requires frequent and ongoing communication between the depositary and the fund's management.

Controls have to be carried out in a timely manner, in order to allow for adjustments to planned

operations and/or transactions to be made if necessary.

Upon provision of the relevant data, sufficient time must be allowed for the depositary to perform its controls.

The depositary cannot play a passive role and should proactively pursue this dialogue, asking pertinent questions and requesting relevant documents as circumstances require.

Additional courses of action may be necessary, as detailed hereafter in the sections related to acquisition and disposal of properties.

12. What are the limitations of the depositary's work (*force majeure*, *serious fraud*, etc.)?

The obligations and level of reliance that can be attributed to a depositary which is safekeeping cash and assets that must be held in custody (directly or through sub-depositary arrangements), are not different to the normal obligations of a Luxembourg custodian acting in respect of a traditional UCI. This will not be expanded upon in this document.

As mentioned above, a depositary has a safekeeping role over assets which are not held on deposit or which are not possible to keep in custody (and in particular real estate assets held directly or indirectly through legal entities).

Being able to perform the safekeeping duties, the depositary needs to gather a fundamental understanding of the fund structure and especially the transfer of ownership.

In this sense, the depositary can only verify that the fund manager and the governing body take reasonable steps to secure ownership of assets and to ensure that the benefits of fund transactions flow through to investors as foreseen in the fund documentation, but the depositary cannot act as guarantors in this matter.

More specifically, ownership of real estate is a complex legal matter and varies significantly

¹⁰ See ALFI & ABBL Guidelines and Recommendations for depositaries (17 May 2018)

depending on jurisdiction. The depositary is not a legal expert and can only verify that the fund manager and the governing body have taken reasonable steps to secure and protect ownership of properties and controlled subsidiaries.

In addition, there are many environmental and operating risks involved in the business of REIF which are outside the capacity of the depositary to control. For instance, the depositary cannot control if the value of a property decreases due to physical or general economic circumstances, or if the ownership of the asset is compromised by political or legal developments which are inherent in the operating environment of the fund. Furthermore, the depositary is not responsible for assessing counterparty risk, the adequacy of the investment policies of the fund or the wisdom of any particular investment or financing decision.

The sufficiency of the extent of the depositary's work is therefore a highly judgmental matter. There are circumstances of force majeure or serious fraud or insolvency which would be judged outside the responsibility and control of a depositary acting in good faith and with due care.

13. What are the responsibilities and rights of a depositary in conducting its supervisory function?

13.1 The knowledge of the depositary

According to CSSF Circular 18/697, the depositary:

"[...] must have knowledge at any time on how the assets of the UCI have been invested and where and how these assets are available".

What does this mean for a real estate fund?

In a general sense the depositary should understand the fund product, its legal form and structure, which assets are held in the fund and the processes through which they are acquired, held and sold. This should include an understanding of the risks related to the availability of assets and how the asset manager and its delegates manage such risks.

In a practical sense, the depositary will gener-

ally build a file documenting the fund product (prospectus/private placement memorandum, regulations, investment strategy and restrictions) as well as make inquiries and collect evidence as to how assets are acquired, held and sold by the fund, the controls over such processes and details of how economic benefits of transactions flow back to investors during the holding period and on exit.

More specifically, in relation to the underlying assets of the fund, the depositary should have knowledge of:

- The nature of underlying property assets (land, buildings, joint ventures, associate companies, etc.) of the fund, and reasonable evidence that these assets are beneficially owned by the fund or through controlled legal vehicles.
- The nature of any material mortgages and pledges over assets of the fund and reasonable evidence that these are within the scope of the funds permissible financing activities as described in the fund documentation.
- The chain of ownership via intermediary legal structures through which the underlying real assets in the fund are held.

In general, the depositary is not allowed to delegate any of its functions except for safekeeping function under specific conditions as set out in Art. 19 (11) of the AIFM law and explained in detail in Art. 98 and 99 of the Level 2 regulation.

Where the safekeeping of assets has been delegated to a third party, the depositary is obliged to ensure that the third party meets the specific conditions "at all times".

13.3 The depositary's assessment of the availability of assets

In general, the depositary has to verify that, and in which manner, the underlying assets are beneficially owned by the fund and that, and in which manner, the economic benefits of fund transactions (acquisitions, disposals, and repatriation of income) flows through to investors in accordance with the fund documentation.

Real estate funds can be complex. Assets are

often held through multi-level holding structures. Funds can own beneficial interests in land, development projects, stable income generating properties, joint ventures or real estate securities or positions in other real estate related businesses. Sometimes assets are not fully owned and controlled by the fund. Assets are often subject to pledges and mortgages which may legitimately compromise the ownership of assets by the fund in certain circumstances.

There are many different approaches to the frequency and the method by which income and capital gains are repatriated to investors through the fund structure. In addition, the real estate title is sometimes, depending on its jurisdiction, imperfect but is judged by the fund to be adequate for their purposes. The depositary may also have different strategies depending on its assessment of the strength of internal processes and controls performed under the supervision of the management of the fund, in preventing or detecting errors or irregularities.

All these factors impact the work of the depositary in how they execute their supervision. The nature and frequency of their procedures will depend on their assessment of the risks related to the availability of the assets. This will vary from fund to fund and from one jurisdiction to another, and the approach of the depositary needs to be tailored to ensure effective and practical supervision is applied in each case.

13.3 The means of a depositary

What rights and means does the depositary have to exercise its obligations?

The depositary is required to use all means it deems necessary to fulfil its responsibilities, including access to information held by third parties. Such access should be facilitated by the governing body of the fund, and therefore should be considered when any third parties are engaged for services or contracts and agreed with counterparties. The governing body of the fund should ensure that the depositary is able to execute its work efficiently, in a timely manner and without hindrance.

The Level 2 regulation defines the general re-

quirements a depositary has to apply. To fulfil the oversight duties, the depositary shall perform ex-post controls and verifications of processes and procedures established by the AIFM, the AIF or an appointed third party. This includes e.g. the work of an external valuer as well as the Central Administrator of the AIF who is calculating the NAV.

Generally, the depositary will develop a plan, including the means through which it will meet its obligations and the evidence it will collect to document its work. This may include:

- Information about the fund;
- Independent confirmations;
- Fund, advisor or third party service provider records;
- Reliance on the work of others (e.g. legal opinions on property ownership);
- Details of policies and procedures relating to fund operations;
- Use of public available information, such as land and company registers;
- Other alternative procedures.

Given the wide range of fund products, structures and underlying assets, the depositary may use a variety of means to carry out its supervision.

13.4 The independence of a depositary

The independence of the depositary derives principally from its role of safe keeper of the assets on behalf of the investors.

The first reference in a Luxembourg law text goes back to the first UCITS Directive that incorporates the principle of separation and ethical independence between the fund manager and the depositary stating that both “the management company and the depositary must act independently and solely in the interest of the unitholders”.

Art. 19 of the AIFM Law clarifies that the AIFM is not allowed to act as depositary. Also, prime brokers acting as counterparty to an AIF should generally not act as depositary, unless there is a functionally and hierarchically segregation between the two functions and potential conflicts of interest are identified, managed, monitored and disclosed to the investors.

What should a depositary do in practice?

1. Introduction

The practical role of a depositary has been subject to frequent debate and different interpretations. This was particularly evident in relation to alternative investments, such as real estate, where the depositary is entrusted with an ownership and existence verification (safe-keeping) as well as a supervision duties, rather than custody. The AIFMD has set up the rules and defined the responsibilities of a depositary. The depositary's duties are elaborated upon in the section below with respect to the different stages of the lifecycle of a real estate fund.

2. Fund Set-up (Planning)

During the set-up phase, the depositary needs to be kept informed by the promoter/manager to understand the complexity of the fund, its strategy and the governance framework in order to put together an appropriate depositary strategy.

The depositary should plan its work so that it performs its role in an effective manner, ensuring that appropriate attention is devoted to important areas of supervision, and that any potential problems are identified and resolved. The nature and extent of planning activities will vary according to the size and complexity of the fund, the depositary's prior experience, recent market developments and changes in the business activity of the fund.

At the planning stage, a depositary develops a strategy of its supervision role and a detailed plan of work. As the depositary is depending on information provided by third parties, especially the AIFM and/or the Fund itself, the depositary contract needs to include "...a description of the way in which the safe-keeping and oversight function is to be performed depending of the types of assets and the geographical regions in which the AIF plans to invest."

The strategy should set the scope of the depositary's involvement and takes into account the fund profile, investment strategy and lifecycle stage. The strategy is risk based and should include an analysis of events and circumstances that could potentially give rise to financial losses, fraudulent activities or any other matters that

would lead to a breach of the fund's, legal or regulatory regulations.

Once the strategy is set, the depositary is able to develop a more detailed work plan, including specific procedures. At this stage, the depositary has to also verify the existence of robust processes and procedures at the AIF, AIFM and third party providers supporting the fund such as the Administrator and Transfer agent. These reviews are generally conducted on an annual basis. Existing controls reports (e.g. ISAE 3402 Type II) would simplify this verification.

3. Understanding the ownership structure

The depositary should be able to demonstrate its understanding of the chain of ownership of properties via various SPVs by reconciling the latest fund organisation chart and/or fund documentation received from the fund's management with its own records. As mentioned earlier, the ownership and existence check has to be applied on a look through principle. The fund organisation chart may usefully include ownership percentages including minority holdings, and should be updated with further acquisitions, disposals or SPV changes as the case may be.

Throughout the life of the fund, on a regular basis, the depositary should reassess or seek reconfirmation of the ownership structure of the fund, either from the fund's management or via external evidence. The depositary should be informed by the fund's management prior to any planned incorporation of a subsidiary to be established for any purpose, such as acquiring, structuring or developing any property or investment.

The depositary should be able to verify, as circumstances require, any interruption of the chain of ownership between property and fund through all subsidiary SPVs. Verification should be possible through a combination of confirmations provided by the fund's management, the fund's legal advisors or other advisors and its own independent research or advice.

The chain of ownership may be demonstrated through control or review of the updated registers of shareholders, partnership agreements etc. of

the various SPVs and intermediary structures. Access to shareholder registers may vary on a case-by-case basis. Ideally, the depositary, or its local agents would monitor any issuance and transfer of shares and ensure that they are effectively recorded. To enable monitoring on a real time basis the depositary may be given direct electronic access to the register, if available.

In foreign countries, in the absence of local partners with knowledge of local legislation in force, the depositary may have to find alternative paths. For instance, it may choose to rely on legal opinions issued by a reputable local lawyer, may review copies of relevant documentation, or request confirmations from public sources such as government or commercial shareholder registries and/or notaries. Consideration should be given to the qualification and experience of any agents used for confirmation of ownership or registration.

The fund's management should use reasonable efforts to keep the depositary updated and to provide the depositary with the relevant documentation and board resolutions related to any changes in the valuation of the real estate and events in the corporate life of the fund, any intermediary structure or the SPVs that may affect the legal structure or the ownership structure of the fund, such as change of registered office, name, shareholding, mergers, liquidations etc.

The depositary should be made aware of and receive regular access to information regarding any third-party banks and/or cash accounts opened and owned by the fund or SPVs, for their own specific needs or held in the context of the management of the properties.

Relevant determination of control principles (e.g. accounting principles, management control, etc) should be used to decide whether a SPV should be treated as (i) a target investment or (ii) holding company. The latter case normally requires a look-through to the underlying assets of such SPVs as the ultimate assets of the fund. In contrast, "target investments" constitute investment into operating entities which are not directly managed on a day-to-day basis by the fund, for example private equity investments and/or joint ventures.

4. Real Estate acquisition

4.1 Typical steps in Real Estate acquisition

Acquisitions are key transactions where the depositary should execute its supervisory obligation and verify asset ownership.

The depositary has to be informed of the details of a transaction by the AIFM or the REIF with sufficient time to act, to allow smooth processing and the resolution of enquiries, thus avoiding delays to completion of the transaction and/or negative consequences for the fund.

Essentially there are three layers of check that a depositary will carry out:

- Asset level:

At asset level, depositary checks aim to validate the acquisition of the asset itself.

- Fund level:

At fund level, depositary needs to monitor the flow of money from the top to the bottom of the structure to validate the chain of ownership of the assets.

- Corporate governance:

From a corporate governance perspective, a depositary will check that the acquisition has been authorised according to the governance framework set up by the fund. All relevant board, management and committee approvals such as transaction, advisory or investment committee's minutes must be provided to the depositary in order to authorise the acquisition. The depositary must also receive board minutes of any relevant SPV approving the acquisition.

Supervisory duties during acquisitions are carried out through the entire process with documents available pre-closing, at closing and post-closing; once again it is important that a robust communication protocol is established between the Manager and the depositary.

Depending on the countries where transactions are done, Depositary might ask for a translated version of the relevant document.

Depending on the fund's set-up, the various steps in the depositary's acquisition review process could be summarised as follows:

- Receipt of information and draft documen-

tation on transaction and constitution of transaction file;

- Review of transaction and contact with management to resolve issues, if any;
- Review of compliance of transaction with local law, fund documentation and management regulations/articles of incorporation;
- Receipt of valid payment instructions for acquisition;
- Receipt of relevant board and/or management approvals;
- Follow up on completion of transaction until receipt of finalised and executed documentation, such as copies of sales agreements and title deeds.

Art. 92 of the level 2 AIFM regulation describes the general requirements of the oversight duties. In practice, the depositary should obtain with respect to asset acquisitions reasonable comfort that:

- The acquisition has been duly authorised by management, having regard to due diligence reports or other means to ensure that ownership of the target property assets can be held by a fund and that title ownership risks have been considered by management;
- The proposed documentation and payment instructions are coherent with the contemplated transaction
- The transaction complies with the law and the management regulations (i.e. investment restrictions compliance);
- Where there is a significant difference between the purchase price and the independent valuation (i.e. the purchase price is significantly higher than the valuation), such material differences have been explained by management in writing. In practice, the valuation should not be older than 6 months preceding the transaction date.

There are often working protocols established between the depositary and the fund to specify the nature and timing of procedures required to be performed and related documentation to be obtained by the depositary in pursuit of its responsibilities.

5. What are the types of evidence typically requested by a depositary related to an acquisition?

Although this list is not exhaustive and may depend upon specifics of a particular transaction, types of relevant evidence could include the following items:

- Acquisition recommendation from the fund manager/advisor to the fund and the Investment Committee/Investor's Advisory Committee (if applicable);
- "Independent Valuer" property valuation, with any significant difference between purchase price and valuation explained in writing by management;
- Details of proposed external financing (lender and mortgage structure);
- Draft copies of transactional documentation such as property purchase agreements and/or share purchase agreements;
- Copies of corporate formation documents of all SPVs involved in the transaction;
- Legal, financial and tax due diligence reports on property title and relevant SPVs (including legal and/or AML opinions regarding counterparties);
- Investment Committee/Investor's Advisory Committee resolutions related to the proposed transaction (if applicable);
- Details of projected cash movements related to the transaction showing parties involved financially in the transaction;
- Details of any banks and bank account numbers that will be used for the transaction;
- Copies of any related collateral agreements such as escrow agreements;
- Confirmation of insurance arrangements;
- Copies of any title insurance arrangements (if applicable);
- Translation of relevant documents (if applicable).

6. How should the depositary process the payment required for an acquisition?

The following actions should be performed by the depositary:

- Check that valid payment instructions have

- been issued for the proposed transaction;
- Check that settlement details provided are consistent with the specifics of the transaction, in particular in the case of settlement through an escrow agent, legal advisors or notaries;
- Perform or seek confirmation of proper execution of payments for the acquisition.

7. What action is required after payment of the acquisition price?

The depositary should obtain copies of all relevant executed documentation evidencing the ownership of the assets acquired by the fund, such as:

- Property title deeds;
- Share purchase agreements;
- Updated SPV shareholder registers;
- Third party financing and security agreements.

The records of the depositary should be updated to reflect the acquisition and any change in liabilities of the fund.

8. Holding

During the holding phase, when the fund is not buying nor selling assets, the role of the depositary is essentially focused on keeping the understanding of the funds and its operations.

On a day to day basis, the depositary is involved in any cash transfer at the level of the fund, where it has to perform daily cash flow reconciliations. It should also be informed about any changes in the holding structure such as merger and liquidations of SPVs (in case of restructuring) or new financing in place.

On a regular basis, a static check is performed on the assets of the fund, with the aim to get updated documents and independent confirmations. Examples of those checks might include: land registers, intercompany confirmations, list of bank accounts held by the fund and its SPVs, list of derivatives and extracts of chambers of commerce confirming the chain of ownership.

9. Ongoing supervision

Asset type	Means of supervision
Investor commitments, i.e. claims of the real estate fund against the investors pursuant to the subscription agreements, which provide for a mechanism of capital calls in order to draw down capital commitments.	Verify with the fund's management that reasonable precautions have been taken in order to ensure the validity of outstanding commitments; the depositary should receive on a regular basis a statement of commitments and any pledges or other agreements affecting these rights, paid and unpaid, from the transfer agent.
Portfolio investments such as non-listed interests in real estate co-investment vehicle or joint-venture type funds.	Record portfolio investments in real estate joint-venture type vehicles or operating companies. In some cases, 'controlled' subsidiaries that are significant operating companies, may be treated as portfolio investments and thus not dealt with on a 'look-through' basis; this would be determined on a case-by-case basis.
Cash or securities (equity or debt) at the level of the fund, deposited with third party banks and/or prime brokers	Receive prior notification of the third party institution(s) with which the fund makes deposits of cash or securities, and the relevant account numbers. The depositary should receive regular reporting on these assets, either in hardcopy or electronic form.
Cash or securities (equity or debt) at the level of the controlled subsidiaries deposited with third party custodian, bank and/or prime brokers, outside the network of the depositary.	Receive prior notification of the third party institution(s) and the relevant account numbers of deposits of cash or securities assets. The depositary may object to these arrangements on a case-by-case basis, either on establishment or at any time thereafter, and may require the fund's management to move the deposits to a different institution. The depositary should have access to regular statements of these assets, either in hardcopy or electronic form. As mentioned earlier, the Cash Monitoring duties do not apply on a look through basis.

Non-listed securities or other similar investments which are not deposited with a third party and are held directly in the records of the issuer in the name of the fund and/or its subsidiaries.	Maintain records or statements of any non-listed securities or assets that are not deposited with a third party; seek assurance that any significant transactions relating to these securities or assets will be subject to prior notification to the depositary with sufficient time to review, with any related cash movements being directed from and/or to accounts at the depositary.
Real estate interests such as land, buildings, leasehold interests and other rights in rem.	Verify that the fund, or its subsidiaries, owns the properties and/or other assets. In this context, the depositary shall hold copies of title deeds, and any other relevant documentation proving ownership of the properties (including where relevant, legal opinions issued by law firms), or related documents held by local parties.
In addition, the depositary should have knowledge of significant liabilities that may affect the assets of the fund, such as:	
Liabilities related to internal and external financing of the fund.	Receive reporting on significant liabilities or encumbrances that may be attached to the fund, its subsidiaries and/or properties (e.g. mortgages), for example by keeping records of all loans outstanding, (internal or external), together with copies of the relevant loan and/or securities documentation.
Other investment activities such as pledges, escrow arrangements, derivatives, etc.	Receive reporting on significant liabilities or encumbrances that may be attached to the SPVs and/or properties (e.g. pledge agreements, escrow agreements and accounts, statements of derivative positions and exposure etc).

The depositary should establish an ongoing risk-based process to periodically update and confirm their understanding of the assets of the fund. The frequency and nature of this process should be determined by considering the risk profile of the fund, the nature and location of assets held, knowledge of internal controls etc.

Such procedures commonly include but are not limited to:

- Confirmations from asset managers and third parties;
- Review of audited financial statements;
- Review of updated fund documentation;
- Review of Board or other governance bodies' minutes;
- Confirmation of bank and securities' accounts held with third parties.

10. Real estate disposal

10.1 Typical steps in Real Estate disposal

Disposals represent another major transaction type where the depositary will update its knowledge of what assets are ultimately held by the fund.

The depositary has to be informed of the details

of the transaction by the AIFM or the REIF with sufficient time to allow smooth processing and the resolution of legitimate enquiries, thus avoiding delays to completion of the transaction and/or negative consequence to the fund.

Depending on the specifics of the fund, various bodies may be involved in the sale, including notably various levels of the fund's management.

10.2 What are the recommended transaction checks for a disposal?

Although this list is not exhaustive and may depend upon specifics of a specific transaction, types of relevant evidence could include the following items:

- Sale recommendation from the fund manager/advisor to the fund and the Investment Committee/Investor's Advisory Committee (if applicable);
- "Independent Valuer" property valuation, with any significant difference between sales price and valuation explained in writing by management. Such valuations should take place if the disposal takes place more than 6 months after the last regular valuation or if any major event took place in that period that could significantly affect the value of the property;

- Information related to the purchaser, including legal and/or AML opinions;
- The transaction complies with the law and investment guidelines
- Draft copies of transactional documentation such as property sale agreements, share sale agreements and any relevant documentation;
- Investment Committee/Investor’s Advisory Committee resolutions related to the proposed transaction (if applicable);
- Details of projected cash movements related to the transaction showing parties involved financially in the transaction, including potential mortgage reimbursements to lenders;
- Details of any banks and bank account numbers that will be used for the transaction;
- Copies of any collateral agreements necessary for the transaction such as escrow agreements;
- Translation of relevant documents (if applicable).

10.3 How does the depositary supervise the disposal?

The documentation regarding the sale and the related board resolutions at the level of both the fund and the relevant SPVs should detail the exact process that has to be followed for the settlement of the transaction:

- How and when the property titles and sale/purchase contracts will be exchanged;
- How the payment will actually take place;
- When the monies are expected to be received.

The depositary should require confirmation from the fund’s management of cash received and the completion of all necessary post- transaction formalities, e.g. via receipt of a closing legal “bible”.

10.4 What actions are required after the completion of the disposal?

- The depositary should receive copies of all relevant transaction documentation, including resolutions and decisions adopted by boards of directors of any relevant SPVs;
- The depositary should also receive confirmation of mergers or liquidation of “empty” SPVs, and closure of bank accounts, (if applicable);
- The records of the depositary should be updated to reflect the sale and any change in liabilities of the fund.
- The depositary should receive copies of all relevant documentation and decisions made in relation to the upstreaming of the cash received further to the disposal of the asset

11. Confirmation and reports

The depositary should be in a position at any time to provide up-to-date confirmation of the assets subject to safekeeping and be in a position to provide a list of assets not held in custody, but subject to their monitoring procedures.

January 2019
© 2019 ALFI. All rights reserved.



**Real Estate Investment Funds:
Depositary aspects**