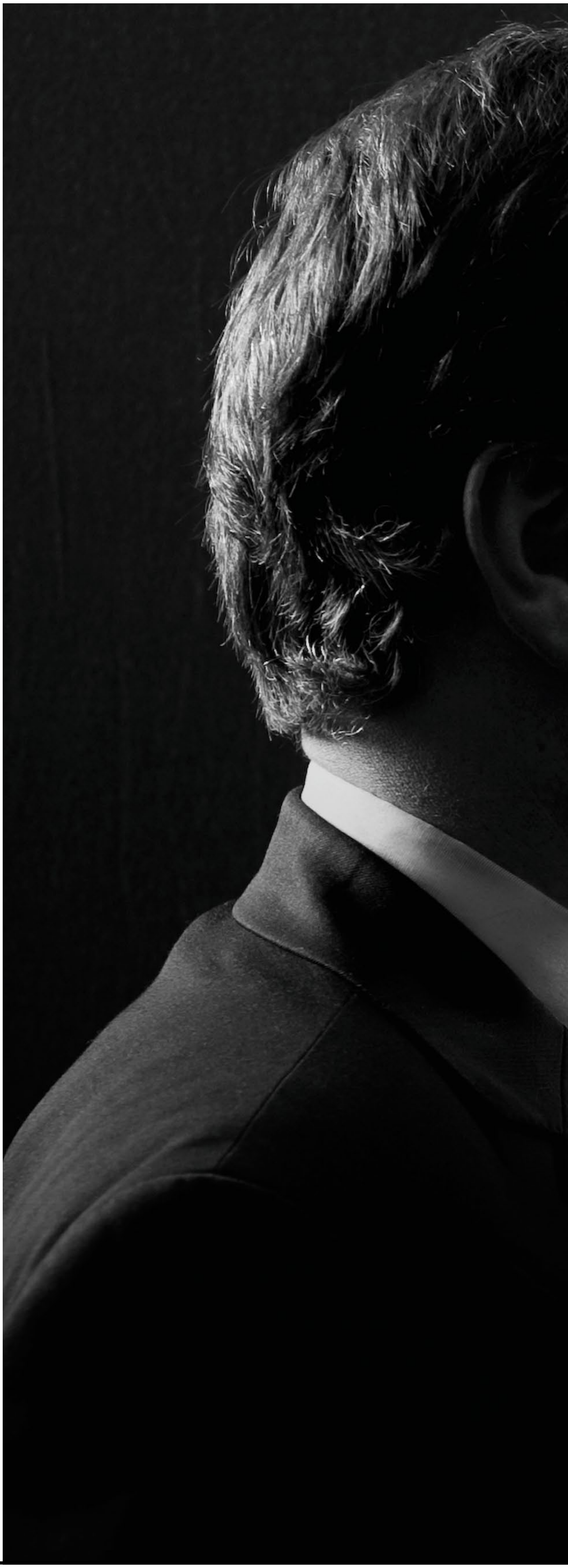


HEAD TO HEAD

A fund administrator and custodian face off in a bid to determine who makes the best private equity depositary.

Words *Brendan Scott*
Photography *Richard Gleed*

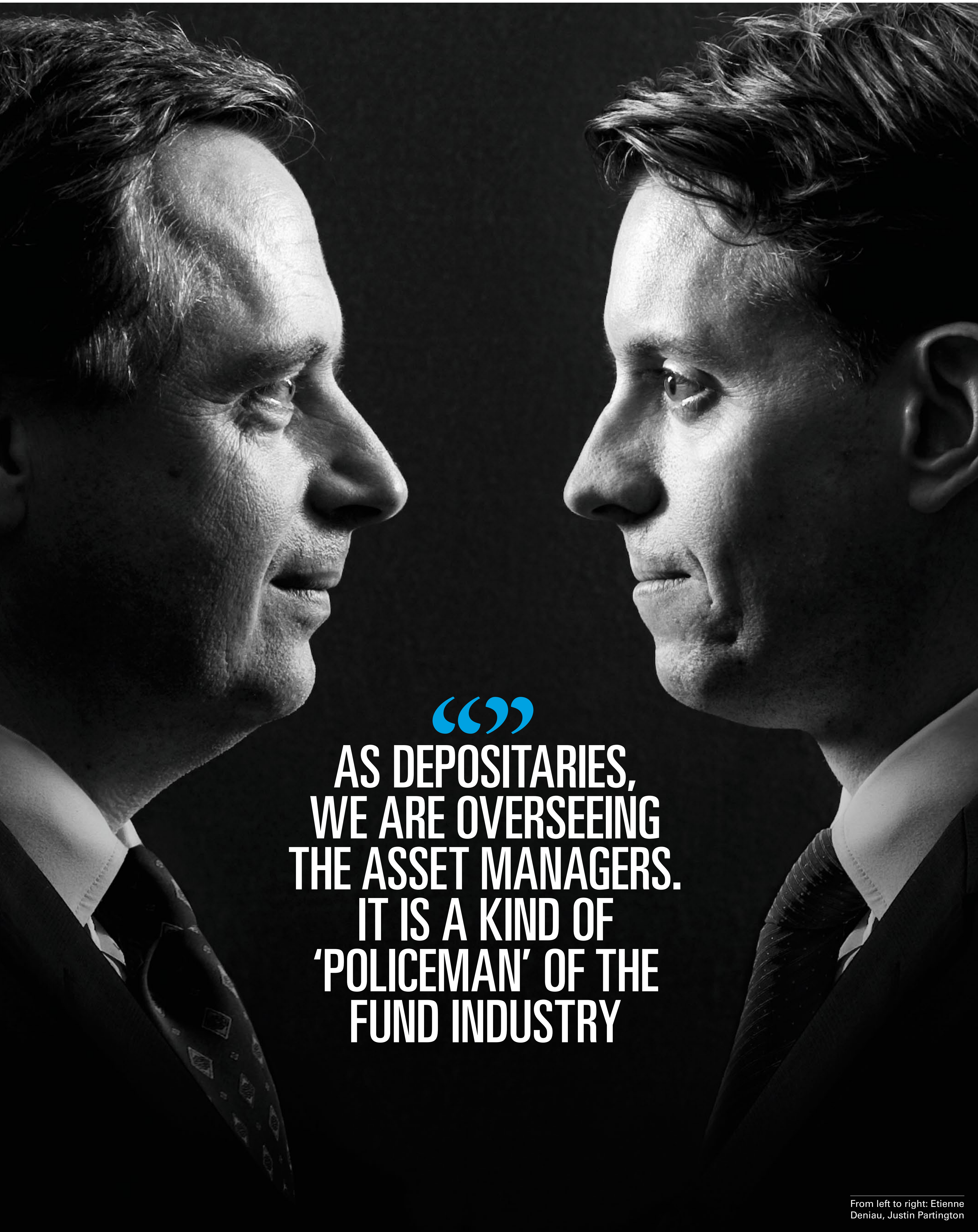
Etienne, the depositary is a new concept for private equity. Could you break down the difference between a custodian and a depositary?

Deniau: Securities custodians operate on the behalf of third-party transactions, servicing the change in ownership of listed securities and all of the corporate events such as distributions and reorganisations. The depositary, meanwhile, is a third party that guarantees compliance of each and every fund – and thus the complete fund industry. Long before depositaries you had trustees in the UK and they had a slightly different role.

Depositaries have limited liability, limited to the fund's value, and have an obligation of result, whereas trustees have unlimited liability with an obligation of means. So the two concepts are quite different. Depositaries already exist in the UK for funds like OEICs. On the continent we've had depositaries for the last 30 or so years, so the AIFM directive is not a revolution, rather it's an evolution.

There have always been three principles for depositaries: the reality of the assets of the fund, whether the assets exist or not; whether the management principles are followed; and fairness between shareholders. The AIFM directive has introduced different principles but they reflect these existing ones. These are safekeeping, which means custody of listed assets with an obligation of restitution and record-keeping of other assets; oversight; and cash flow monitoring. They're the same ideas. Oversight is very broad, while cash monitoring is very strict and means ensuring no money is being lost. So the custodian is only a part of the broader role of the depositary.

It's important to know that tomorrow there will only be three types of asset management in Europe – UCITS, AIFs and mandates. In each country the regulator organises the asset



> AS DEPOSITARIES, WE ARE OVERSEEING THE ASSET MANAGERS. IT IS A KIND OF ‘POLICEMAN’ OF THE FUND INDUSTRY

From left to right: Etienne Deniau, Justin Partington

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IN THE UK WE'VE NEVER HAD DEPOSITARIES IN THE CLOSED-ENDED FUND WORLD OF PRIVATE EQUITY

HEAD TO HEAD

At the table

JUSTIN PARTINGTON, IPES

Partington is the commercial director for Ipes responsible for delivering the global business development and marketing strategy to expand the firm's profile in its key markets, diversify its product range, and grow its revenue base. Partington has spent the last 12 years in fund administration, having led the private equity department of a London-based private equity administrator and worked as a director at UBS Fund Services. Prior to that he spent five years with Deloitte and PwC, where he qualified as a chartered accountant.

ETIENNE DENIAU, SOCIÉTÉ GÉNÉRALE SECURITIES SERVICES

Deniau has been head of business development, asset managers and asset owners at Société Générale Securities Services since July 2012. He started working in 1990 at the futures and options brokerage arm of Société Générale, for which he ran the Tokyo office from 1993 to 1997. He then moved to London to head the firm's local branch for global banking and securities services. In 2000, he left to pursue different opportunities in retail banking, but returned in 2004 as deputy head of investor services and became head of custody and trustee services in 2008.

management licensing as it wishes, but they should basically fit into those three.

Partington: In the UK we've never had depositaries in the closed-ended fund world of private equity, although they have existed for some property and retail vehicles. The language in the UK tends to refer to the "depositary bank", which we tend to think of as the members of the Depositary and Trustee Association. Then you have the new AIF depositary category. The distinction between the two is that depositary banks tend to be full EU credit institutions and they're not restricted by the types of assets they can hold. They have a wider mandate, but both must offer exactly the same service to closed-ended private equity. It is the type of fund and type of asset that dictates what service is required, be it financial instruments or other assets, closed-ended or open-ended funds.

The service offered by both must be the same, but custodian banks and independent fund administrators are very different. Are you concerned about the liability risk that Ipes is taking on and the potential losses if something goes wrong?

Partington: It's always going to be a concern and it's something we take very seriously because it's a new service in the UK and elsewhere. So there are a number of unknowns. What happens when the first asset is lost? Who will take the blame for that and how will the jurisprudence prove out?

What we see is a clear distinction in the AIFM directive between other assets and financial instruments. If an asset is lost as a financial instrument, the depository must return that asset to the fund and investors without any delay, and then later attempt to recover it in court if not at fault. But for other assets there is no strict liability. So the onus is upon the fund to prove that the depositary is at fault for the loss of that asset. The depositary has to be shown to be negligent or not compliant with the directive and that it was not properly overseeing the manager. So the burden of proof is different.

With financial instruments, in my view, it is a case of guilty before proven innocent; with other assets it's the normal tort contract – if you're negligent then you're guilty. There is a clear distinction between the two and at Ipes we're not going to act as the depositary for financial instruments.

But if you're negligent then you stand to bear huge liabilities. Does this not add a significant new layer of risk to your business model?

Partington: That is the same anywhere in the professional services business in the UK. If you're negligent then you're liable. If you're a lawyer and you give bad tax advice and it falls over you are potentially liable. If you're a bank and you send a payment to the wrong account, you're liable. If we in the administration business miss a call on a fund we can be liable for interest and penalties. Our insurers, who have large risk analyst teams and are backed by multinationals, have looked at this and, thus far, they don't see any material difference in the risks between our existing business and our new depositary offering at this stage.

Etienne, do you have any concerns about liabilities now that SGSS has begun acting as a depositary for private equity clients?

Deniau: There are three types of assets and three types of liabilities. The return of financial assets, securities, is usually straightforward. There can be delays if you're dealing with a bankruptcy. In the case of Lehman Brothers, for example, assets would not have to be returned immediately but would have to wait until the bankruptcy has been solved.

For non-listed securities, the depositary has to do the record-keeping and make sure that the assets really are owned by the fund. This can be challenging. If you're in your own country you simply go and see the registrar for the asset and it is usually managed easily. If you work on, say, Greek real estate it may be more difficult to prove ownership. It's easier to perform the depositary duty within your own legal system and often becomes much harder when you cross borders.

The third component, cash flow monitoring, can be challenging and use a lot of resources. When you're a bank this may be easier because the accounts are on your books and you can trust your own organisation. It can be expensive and when you have to rely on third parties it can become a significant challenge. Due to this it might be difficult for new entrants to service all the existing vehicles out there that will need to appoint a depositary.

Is moving into the private equity depositary space a strategic move by SocGen to gain access to the buyout financing market?

Deniau: Clearly not. The credit side of the bank and securities services are completely autonomous from each other. Some of our competitors are forcing bundles but we offer our services independently. If the credit team is ready to do a deal and the customer wants a one-stop shop then we are clearly offering our services, but we act independently from each other.

Partington: One of the questions that we've had is whether we would act as a depositary without taking on the administration. There's major efficiency when you have the two under one roof, but we are happy to act on a standalone basis. Some of our biggest clients have significant in-house teams and they don't want to change that. So working independently is important to us. We hear in the market that some banks are uncomfortable acting as a depositary without the administration side.

Etienne, are you concerned that SocGen is starting from a standstill with regards to private equity relationships where independent fund admins have the existing contacts?

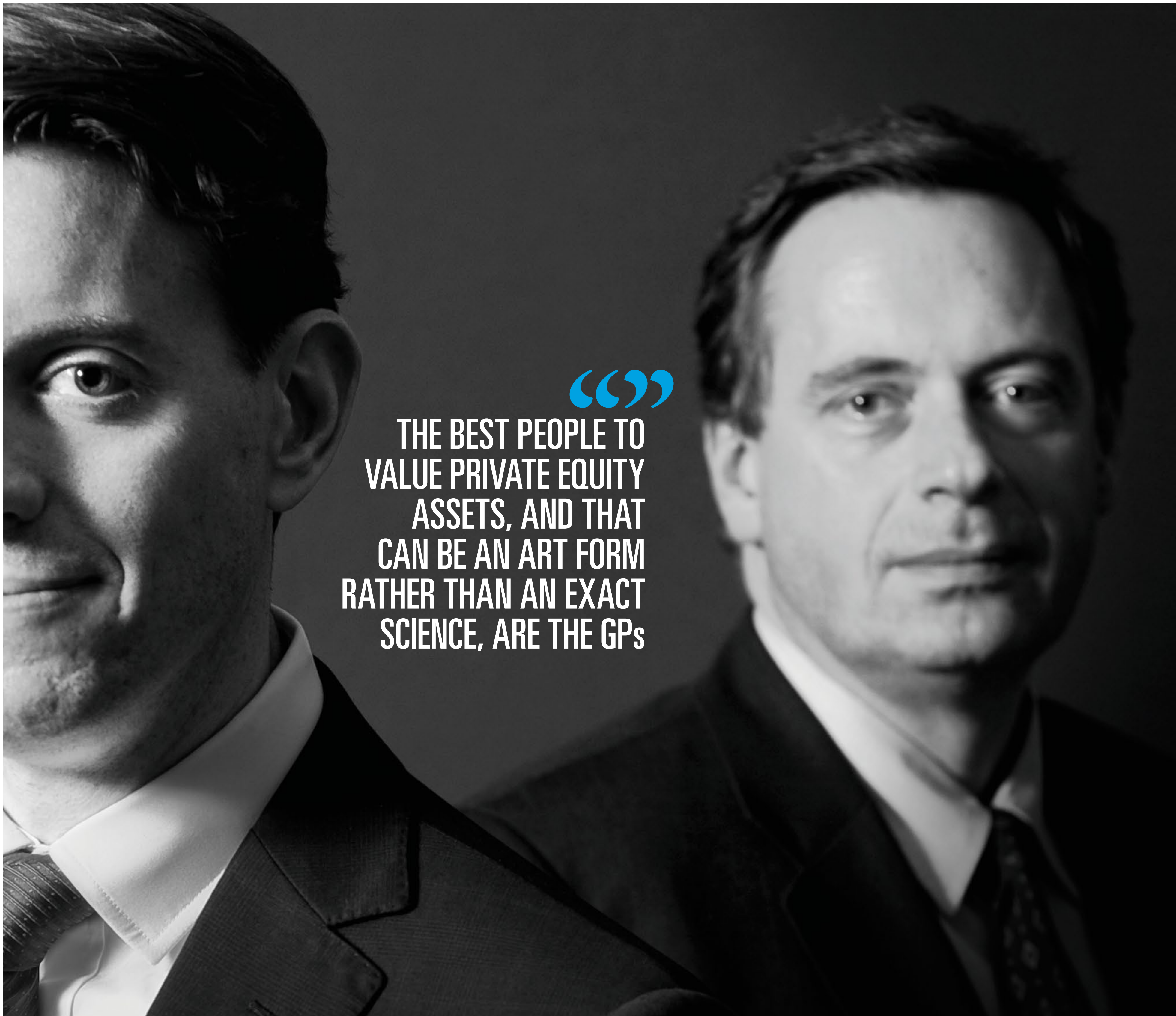
Deniau: It will be difficult of course, but I see it another way because the market is organised differently on the continent. As a depository, we are overseeing the asset managers. For this, the depository is a kind of "policeman" of the fund industry. The fund admin is only a provider for the asset manager.

Furthermore, because of this duty of oversight, we have to be very selective on the asset manager we agree to take on as its depository. And they should be selective too to make sure we are capable of carrying out our duty.

What are your criteria for choosing which clients to service?

Deniau: It's not a question of size but of competencies. If it's a boutique that starts with no experience of private equity then it's a definite no. In the case of Bernie Madoff, the fund administrator was right next door and it was a small boutique. We only work with big names on the fund admin side. It can also be in-house but it has to be properly organised. And we would audit them.

Partington: When it comes to boutiques, one thing you have to remember is we already own a large share of the market. The top five independents in Europe, of which we're one, collectively you're looking at about \$230bn (€167bn) under administration. So across that group we dwarf any one bank's



private equity fund admin activity in Europe today. It's a misunderstanding to think the boutiques don't have an established place in the market. How many banks have more than $50bn of European private equity funds under admin?

Research has called into question the integrity of funds' NAV valuations, which tend to be marked up during fundraising. Is it up to the depositary to value the assets of the funds?

Partington: Absolutely not. We don't have to under the directive. The external valuation requirement was scrapped last year in-between drafts, somewhat to the disappointment of the Big Four I suspect. The best people to value private equity assets, and that can be an art form rather than an exact science, are the GPs. As long as someone senior in the firm, or a senior committee, is giving independent oversight, and stopping dealmakers from valuing their own deals, there should be no problem. Reputation is everything and investors will know if valuations are being cooked because private equity is a closed cash loop. If realised exits do not match interim valuations, investors will take notice. All of our clients have audits. It's a rigorous process and always the most detailed area of review with auditors.

Etienne, what would you say is the main advantage for a private equity firm choosing a custodian bank to be their depositary?

Deniau: We can offer clients advantages. When you choose a depositary with a huge balance sheet you're buying trust and peace of mind at the same time. In big banks the processes are thoroughly managed. Big is not always better, but with depositaries it gives you some inertia. That's the biggest advantage we have over the independents.

As a custodian we are like a factory with millions of transactions and assets being serviced. To update our model, we have created specialist units that can look after new business lines and be very flexible. We have 100 people at SGSS now dedicated to private equity.

Justin, what do independent fund administrators have to offer that custodian banks don't?

Partington: What Etienne says makes a lot of sense. Where we can give a different view is through our history. We've been in business for 15 years in just one niche area, and only doing private equity. A lot of our independent compatriots have ten years' experience or close to that. So we have a real expertise and sector knowledge. We understand the differences between private equity and other asset classes, be it hedge funds, UCITS products and so on. It's a niche focus. You can see the advantages of using a bank – it's a one-stop shop servicing all asset classes and retail fund product ranges. That's definitely an asset. We only service private equity and that's fine so long as our clients are focused on private equity. Fortunately they are and so it makes for a good fit.

Real Deals would like to thank Ipes and Société Générale Securities Services for making this roundtable possible.