

## UCITS V Depositaries:

ESMA's technical  
advice to the  
Commission  
on:

- Insolvency protection  
when delegating  
safekeeping functions
- Depository  
independence



UCITS V aims to improve investor protection by harmonising depositary requirements (among other things) and aligning them with the depositary requirements under AIFMD.

On 28 November 2014, ESMA published its final advice to the European Commission on the content of two of the delegated acts required by UCITS V. These relate to the insolvency protection of UCITS assets when delegating safekeeping, and to the depositary's obligation to be independent of the UCITS and its management company.

On 3 July 2014 the European Commission asked ESMA for technical advice on the content of these depositary related delegated acts. In requesting this advice, the Commission acknowledged that most of the substantive rules and delegated acts in UCITS V are identical to those contained in AIFMD, and stated that the present request therefore focused on two empowerments not present in AIFMD: (1) insolvency protection of UCITS assets when custody of those assets is delegated to third parties and (2) the independence of the UCITS depositary.

In response, ESMA published a consultation paper on 26 September setting out the draft technical advice on those delegated acts. That consultation closed on 24 October.

Over 60 stakeholders responded to the consultation, including the Irish Fund Industry Association, the UK's Investment Management Association and the Association of the Luxembourg Fund Industry. In our [previous newsletter](#), we summarised and compared their responses.

Other respondents stressed the need for any Level 2 measures to be applied in the same way throughout the Union and requested that national competent authorities not be given authority to impose additional requirements in their respective jurisdictions (i.e. "gold plating").

We outline below ESMA's final advice to the Commission in light of the feedback from stakeholders.

### **Advice on the insolvency protection of UCITS assets when delegating safekeeping**

UCITS V provides that a third party to whom the custody functions are delegated shall take all necessary steps to ensure that in the event of its insolvency, any UCITS assets it holds in custody are unavailable to its creditors. ESMA's advice outlines the measures to be taken, as summarised in Appendix 1 below.

### **Advice on the independence requirement**

UCITS V states that "In carrying out their respective functions, the UCITS management company and the depositary shall act independently and solely in the interest of the UCITS and the investors of the UCITS".

In addition, a depositary may not undertake any activities regarding the UCITS management company which could potentially cause a conflict of interest between the UCITS, its investors, its management company and the depositary, unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other conflicting tasks

tan the potential conflicts are properly identified, monitored and disclosed.

ESMA's advice identifies two types of link between the management company and the depositary (namely (a) common management or supervision and (b) cross-shareholdings between these entities) which may jeopardise their independence. It recommends measures to address the risks that may arise. Appendix 2 summarises these provisions.

### **Next Steps**

ESMA will work closely with the European Commission to transpose the technical advice into formal delegated acts.



## Appendix 1 - Advice on the insolvency protection of UCITS assets when delegating safekeeping

1. Where the safe-keeping functions are delegated to a third party, **the third party shall take the following steps** to ensure that any UCITS assets it holds in custody are unavailable to its creditors on its insolvency:
  - a) For third parties located outside the EU:
    - i. make all reasonable efforts including obtaining legal advice to verify that the applicable insolvency laws:
      - ✓ recognise the segregation of the UCITS' assets from the third party's own assets and from the assets of the depositary; and
      - ✓ recognise that the UCITS' segregated assets do not form part of the third party's estate in case of insolvency;
    - ii. ensure that the applicable insolvency laws consider that the UCITS' assets are segregated and unavailable to its creditors on an ongoing basis for the duration of the delegation, and immediately inform the depositary if these conditions are no longer met;
  - b) Wherever the third party is located, within or outside the EU:
    - i. inform the depositary about the applicable insolvency laws;
    - ii. maintain accurate and up-to-date records and accounts of UCITS' assets;
    - iii. provide a statement to each depositary on a regular basis; and
    - iv. maintain appropriate arrangements to safeguard the UCITS' rights in its assets and minimise the risk of loss and misuse.
2. When delegating the safe-keeping functions, **the delegating depositary shall adopt the following measures:**
  - a) consider the following elements when selecting and appointing the third party:
    - ✓ the legal requirements or market practices related to the holding of client assets;
    - ✓ the financial condition, expertise and market reputation of the third party; and
    - ✓ protection or lack thereof attendant upon the regulatory status of the third party;
  - b) where the third party is located outside the EU:
    - i. make all reasonable efforts, including obtaining legal advice from an entity not affiliated to the depositary, to understand the material effects of the contract with the third party regarding the UCITS' rights towards its assets;
    - ii. ensure that the contract with the third party allows the termination of such agreement if the applicable insolvency laws no longer recognise the segregation of the UCITS' assets on the third party's insolvency or the conditions set out under these laws are no longer fulfilled; and
    - iii. if the depositary becomes aware that the applicable insolvency laws no longer recognise the segregation of the UCITS' assets on the third party's insolvency or the conditions set out under these laws are no longer fulfilled, immediately inform the management company.
3. The UCITS shall immediately notify its competent authority of such information and consider all the appropriate measures in relation to the relevant assets of the UCITS, including their disposal taking into account the need to act in the best interest of the UCITS and the investors of the UCITS.
4. The above provisions apply in turn to sub-delegates.

## Appendix 2 - Advice on the independence requirement

### Common management/supervision

- a) no member of the management body (ie, the Directors) of the UCITS management company shall be a Director of the depositary;
- b) no Director of the UCITS management company shall be an employee of the depositary, and vice versa;
- c) where the Directors of the UCITS management company are not in charge of the its supervisory functions, a maximum of a third of the members of the body in charge of the supervisory functions shall be a Director or employee of the depositary or form part of the body in charge of the supervisory functions;
- d) where the Directors of the depositary are not in charge of its supervisory functions, no more than one third of the body in charge of the depositary's supervisory functions shall be a director or employee of the UCITS management company, or form part of the body in charge of the UCITS supervisory functions;

### Cross-shareholdings

- e) the UCITS management company shall implement a robust decision-making process for choosing the depositary which shall be based on objective pre-defined criteria and meet the sole interest of the UCITS and the investors of the UCITS;
- f) where:
  - ✓ the depositary has a direct or indirect holding in the UCITS management company of 10 % or more of the capital or of the voting rights or can exercise significant influence over the UCITS management; or vice versa;
  - ✓ the UCITS management company and the depositary are included in the same group for the purposes of consolidated accounts,

at least the following arrangements shall be put in place:

- i. all reasonable steps to avoid conflicts of interest arising from the shareholding or group structure shall be taken and, when they cannot be avoided, conflicts of interest shall be identified, managed and monitored and disclosed
  - ii. the UCITS management company shall demonstrate to the competent authority of its home Member State that it is satisfied that the appointment of the depositary is in the sole interests of the UCITS and its investors;
  - iii. the link between the UCITS management company and the depositary shall be disclosed to investors; and
  - iv. the choice of the depositary shall be justified to investors upon request; and
- g) Where the UCITS management company and the depositary are included in the same group for the purposes of consolidated accounts:
    - i. at least one-third (33%) or two (persons), whichever is the lesser, of the Directors of the UCITS management company and the depositary shall be independent;
    - ii. where the Directors of the UCITS management company and the depositary are not in charge of the supervisory functions, at least one-third (33%) or two (persons), whichever is the lesser, of the members of the body in charge of the supervisory function shall be independent.

Members are deemed independent when they are not members of the management body or the body in charge of the supervisory function nor employees of any of the other undertakings within the group and are free of any business, family or other relationship with the other entities or undertakings within the group that creates a conflict of interest such as to impair their judgment.

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