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ABBL AND ALFI GUIDELINES AND RECOMMENDATIONS FOR DEPOSITARIES

OVERSIGHT DUTIES AND CASH MONITORING FOR AIFS & UCITS



Association des Banques et Banquiers, Luxembourg

The Luxembourg Bankers' Association

Luxemburger Bankenvereinigung

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In association with



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TERMINOLOGY AND CONTEXT

Terminology

Where the terms “management company”/“ManCo” or “Alternative Investment Fund Manager”/“AIFM” are used in the document they refer to the same concept of the entity responsible for the management of the UCITS/AIF.

The terms “shareholders” or “unitholders” are used to refer to investors of the fund (in line with the definition set out in Article 1 (30) of the Law of 17 December 2010).

The term “management/investment company” shall mean either the board of the fund or of its management company, or the boards of both entities as the case may be. It shall mean both bodies where the legal obligation to ensure that the depositary has access to all information and data it needs to comply with its obligations in relation with the oversight and monitoring duties requires both entities to take action. The guidelines refer to Level 1 text meaning the AIFMD (2011/61/EU) and the UCITS Directive (2009/65/EU) and to Level 2 text as their respective Commission Delegated Regulations (CDRs), each as transposed into Luxembourg law. In general, references to bodies of law shall be to their latest version in force, as amended from time to time.

The term “investment manager” refers to the portfolio manager and/or to the risk manager as defined in Annex I of the AIFMD-CDR, as the context requires.

Context

These industry practice guidelines are designed to help with the implementation of and compliance with the UCITS and AIFM Directives and Regulations as transposed into Luxembourg law. They aim at proposing practical approaches and operational solutions, they are not compulsory and they do not replace legal provisions nor legal advices.

EXECUTIVE SUMMARY

In order to define its oversight programmes and procedures, the depositary should undertake, prior to commencement of its duties, an initial assessment of the risks associated with the nature, scale and complexity of the fund's strategy and the organisation of the management company ("ManCo")¹, investment company or the Alternative Investment Fund Manager ("AIFM"), hereinafter referred as to the "management/investment company". From this initial assessment and applying a risk-based approach, the depositary shall decide on the level of due diligence it needs to implement and the number of periodic controls it needs to undertake.

The role of the depositary is to be understood as a supervision role and therefore, it should ensure that appropriate processes are in place and focus on exceptions and risky items rather than double-checking and/or duplicating every single process as implemented by the management/investment company or its delegates.

The depositary needs to perform its role in an effective manner, ensuring that appropriate attention is devoted to important areas of oversight, and that any potential problems in scope for the depositary's supervision activities are identified and resolved on a timely basis.

The depositary is required to perform ex-post verifications of the processes and procedures that are under the responsibility of delegates of the fund, or the management/investment company as deemed relevant in the context of the discharge of the depositary's regulatory obligations. This verification might take the form of either a due diligence/on-site review, or an independent re-performance of the controls and/or a combination of both. The depositary may wish to consider reviewing such processes and procedures at least once a year and each time when a substantial change requires a review (for example in case of a new regulatory requirement). The depositary will need to have sufficient and qualified

resources to perform the assigned oversight and cash monitoring tasks.

To comply with its oversight obligations, the depositary will need to be supplied with all relevant information it needs from available and reliable sources, notably from the management/investment company or from appointed delegates of the management/investment company. The depositary shall also obtain the required information on controls and escalation process from the management/investment company or its delegates. Finally, the depositary may enquire and leverage where deemed appropriate, on the performance of the due diligence review of the management/investment company over its delegates. The depositary may rely on figures and information provided by delegates and the third-party service providers or counterparties to the fund that are deemed accurate.

While the depositary is responsible for the performance of its primary duties, the management/investment company remains responsible for oversight of actions carried out by its delegates and has to deal with issues identified and settle them in the best interest of its unitholders/shareholders.

¹ Chapter 15 or chapter 16 Management Company under the Law of 2010.

OVERSIGHT DUTIES – REGULATORY FRAMEWORK

OVERSIGHT DUTIES – GENERAL REQUIREMENTS

The general requirements relating to the depositary's oversight duties are described in Article 92 of the AIFMD-CDR² which clarifies the duties and rights from Article 21 (9) AIFMD and Article 3 of the UCITS-CDR clarifying Article 22(3) of the UCITS Directive. These general requirements relate to ex-ante risk assessment, where deemed appropriate by the depositary, and mandatory ex-post controls to be undertaken by the depositary.³ The provisions in the AIFMD-CDR and the UCITS-CDR acknowledge that, while the processes and procedures for exercising the oversight functions should be proportionate to the estimated risks of the relevant fund⁴ and without prejudice to the depositary's ability to conduct appropriate ex-ante verifications, the focus shall mostly be on verification checks done ex-post as second-level controls.

The cash monitoring obligations imposed on depositaries, while not addressed as part of the oversight duties, are nonetheless complementary, given that they require the depositary to have a full overview of the cash position and cash movements of the fund, including subscription monies. The requirements relating to the cash monitoring are described in Articles 85 and 86 of the AIFMD-CDR (Article 21(7) of the AIFMD) and in Articles 9 and 10 of the UCITS-CDR (Article 22(4) of the UCITS Directive).

Initial risk assessment

At the time of its appointment and prior to commencement of its duties the depositary should set up procedures and processes which are proportionate to the risks exposure of the fund and the assets in which it invests. Upon its appointment the depositary is therefore required to make an assessment⁵ of the most significant

risks to be controlled for the specific fund taking into account various factors (e.g. the size and complexity of the fund and of the management/investment company, the type of assets and the targeted markets, the fund's trading frequency etc.).⁶ The rationale behind this initial risk assessment is to design a depositary's supervision programme deemed appropriate for the fund's risk profile. This initial supervision programme may have to be adapted during the life cycle of the fund should a material change occur impacting its risk profile.

Ex-post controls

Pursuant to Article 92 (2) of the AIFMD-CDR and to Article 3 (2) of the UCITS-CDR the depositary shall perform ex-post controls and verifications of processes and procedures that are under the responsibility of the management/investment company or any appointed third party (e.g. administrator, prime broker, accountant, etc.). In addition, the depositary needs to ensure that appropriate verification and reconciliation procedures exist which are implemented and applied at the level of the management/investment company or any appointed third party and which are frequently reviewed. In addition the management/investment company must ensure that all instructions related to the fund's assets and operations are sent to the depositary so that the depositary is in turn able to perform its own verification or reconciliation procedure.

The depositary should have its own clear and comprehensive escalation procedure in the event it detects something potentially irregular in the course of its oversight duties, those should be provided to the supervising authorities upon request.⁷ For both AIFs and UCITS, such a procedure should go as far as including the notification to competent authorities of any material breach.⁸

² Please find references to the Regulations on page 27 in the glossary.

³ Recital 106 AIFMD-CDR.

⁴ Cf. Art. 92 (1) AIFMD-CDR; ESMA/2011/379, page 165; UCITS-CDR Art. 3.

⁵ For example with a risk-based approach via the use of due diligence questionnaires.

⁶ ESMA/2011/379, page 165.

⁷ Cf. Art. 92 (3) AIFMD-CDR and Art. 3 (3) of UCITS-CDR.

⁸ Footnote 5 plus ESMA/2011/379, page 165.



Lastly, and as deemed relevant in the context of the discharge of the depositary's regulatory obligations the management/investment company shall particularly ensure that the depositary is able to have access to the books and perform on-site visits on premises of the management/investment company (if deemed necessary) and of those of any service provider⁹ appointed by the management/investment company, such as administrators or external valuers (AIFMD only) and, as the case may be, or to review reports and statements of recognised external certifications by qualified independent auditors or other experts in order to ensure the adequacy and relevance of the procedures in place.¹⁰ In summary depositaries have the following responsibilities when carrying out oversight duties:

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- Assessing the risks associated with the nature, scale and complexity of the fund's strategy and the management/investment company's organisation;
- Conducting ex-post control checks and verifications of processes and procedures;
- Having a clear and comprehensive escalation procedure up to the supervisory authorities to deal with situations where potential irregularities are detected;
- Being able to perform on-site visits of any service provider¹¹ and/or review reports and statements of recognised external certifications by qualified independent auditors or other experts, if deemed necessary.

SUBSCRIPTIONS/REDEMPTIONS

Depositaries have the duty to ensure that the sale, issue, repurchase, redemption and cancellation of units or shares of the fund are carried out in accordance with the applicable national law and the fund rules or instruments of incorporation of the fund.¹²

⁹ For the purpose of this document, we use the term "service provider" to designate the fund administrator or the transfer agent etc.

¹⁰ Art. 92 (4) AIFMD-CDR, and Art. 3 (4) of UCITS-CDR.

¹¹ Cf. ESMA/2011/379, page 164.3 Recital 106 AIFMD-CDR.

¹² Art. 21 (9)(a) AIFMD, and Art. 22 (3)(a) UCITS Directive.

In order to comply with those requirement depositaries shall ensure (inter alia due diligence and controls) that the management/investment company or where applicable, the designated entity (transfer agent) establishes, implements and applies appropriate procedures to:

- Reconcile the subscription orders with the subscription proceeds, and the number of units/shares issued with the subscription proceeds received by the fund;
- Reconcile the redemption orders with the redemptions paid, and the number of units/shares cancelled with the redemptions paid by the fund;
- Verify on a regular basis that the reconciliation procedure is appropriate.¹³

The depositary has to ensure and regularly check that the procedures regarding the sale, issue, repurchase, redemption and cancellation of units/shares of the fund comply with the applicable national law and with the fund rules or instruments of incorporation and verify that these procedures are effectively implemented.¹⁴

In this context it should be noted that ESMA clarified in its Final Report that it believes that the above mentioned requirements should be limited to the sales of units/shares by the AIF or the AIFM for a number of reasons. For example, it would not be materially possible to suggest the depositary should ensure, compliance with applicable law and AIF rules regarding the sales on the secondary market.

The depositary should limit the scope of its review to the population of shareholders as included and reflected in the registrar of the official transfer agent and not throughout the entire chain of distribution.

The frequency of the depositary's oversight duties shall be proportionate with the frequency of subscriptions and redemptions.¹⁵ The frequency of these controls should be defined, for open or closed ended funds, at the time of the depositary's appointment.¹⁶

¹³ Art. 93 (1) AIFMD-CDR, and Art. 4(1) of UCITS-CDR.

¹⁴ Art. 93 (2) AIFMD-CDR and Art. 4(2) of UCITS-CDR.

¹⁵ Art. 93 (3) AIFMD-CDR and Art. 4(3) of UCITS-CDR.

¹⁶ ESMA/2011/379, page 166.

VALUATIONS OF SHARES/UNIT PRICING

With regard to the duty to oversee the valuation of units/shares of the fund, the depositary has to ensure that the value of the units/shares is calculated in accordance with the applicable national law, the fund rules or instruments of incorporation and for AIF the procedures laid down in Article 19 AIFMD¹⁷ (external valuer). Article 94 of the AIFMD-CDR and Article 5 UCITS-CDR clarify this duty entails the following requirements:

- Verify on an on-going basis that appropriate and consistent procedures are established;
- Ensure that the valuation policies and procedures are effectively implemented and periodically reviewed;
- Have procedures that are proportionate to the nature, scale and complexity of the fund;
- Where the calculation of the value of the units/shares of the fund has not been performed in a compliant manner, notify the management/investment company and ensure timely remedial action has been taken in the best interest of the fund's investors;
- For an AIF, where applicable, check that an external valuer has been appointed (Article 19 of the AIFMD).

The management/investment company is fully responsible for the valuation process. As such, the depositary is not expected to recalculate the Net Asset Value ("NAV") but to ensure that appropriate procedures are in place to perform the NAV calculation and that they are effectively implemented (see section IV.VIII of ESMA/2011/379).¹⁸ Therefore, the depositary should take all necessary steps to ensure that appropriate valuation policies and procedures for the assets of the fund are effectively implemented, through the performance of sample checks or by comparing the consistency of the change in the NAV calculation over time with that of a benchmark or

other equivalent procedures. Another approach may be a check on the NAV discrepancy of the actual NAV in comparison to the last NAV, if a pre-defined threshold has been crossed. When setting up its procedures, the depositary should have a clear understanding of the valuation methodologies used by the management/investment company or the external valuer to value the fund's assets.¹⁹

The frequency of the depositary's checks should be proportionate to the frequency defined in the valuation policy.

The depositary does not need to check the valuation every day even if the NAV calculation is performed daily, it shall define – applying a risk based approach – an appropriate frequency of enquiries proportionate with a daily NAV calculation to be satisfied that the value of the shares is calculated in accordance with applicable law and regulation and the fund rules and instruments of incorporation.²⁰

If the depositary is not satisfied that the procedures are appropriate and/or effectively implemented and in situations where the depositary considers that the calculation of the value of the shares or units of the fund has not been performed in compliance

with applicable law or the fund rules or with Article 19 of the AIFMD, it shall notify the management/investment company and ensure that timely remedial action is taken in the best interest of the investors of the fund.²¹

Where an external valuer has been appointed, a depositary has the obligation to check that the external valuer was appointed in accordance with Article 19 AIFMD and its implementing measures.²²

Lastly, the management/investment company should inform the depositary as soon as a material NAV calculation error has been identified.

¹⁷ Art. 21 (9) (b) AIFMD.

¹⁸ ESMA/2011/379 page 168.

¹⁹ Recital 108 AIFMD-CDR.

²⁰ ESMA/2011/379 page 168.

²¹ Art. 94 (3) AIFMD-CDR.

²² Art. 94 (4) AIFMD-CDR.



DUTIES RELATING TO THE CARRYING OUT OF ManCo/AIFM INSTRUCTIONS

The depositary has to carry out the instructions of the management/investment company, unless they conflict with the applicable national laws, the fund rules or instruments of incorporation.²³

In order to comply with the above mentioned requirements Article 95 AIFMD-CDR and Article 6 of the UCITS-CDR further clarify that a depositary shall at least:

- Set up and implement appropriate procedures to verify the compliance of the fund and/or management/investment company with applicable national law and regulation as well as with the fund's rules and instruments of incorporation;²⁴
- In particular, monitor compliance of the fund with investment restrictions and leverage limits of the fund. This is an ex-post requirement, although an ex-ante approach might be necessary in certain circumstances (e.g. property);²⁵
- Set up and implement escalation procedures up to the supervisory authorities for situations where the fund has breached one of the limits or restrictions referred above.²⁶

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By virtue of its obligation, the depositary should set up a procedure to verify on an ex-post basis the fund's compliance with applicable law and regulations and its rules and instruments of incorporation.²⁷

The compliance with the laws and regulations regarding investment is, in the first and foremost instance, the obligation of the management/investment company.

²³ Art. 21 (9) (c) AIFMD and Art. 22 (3) C of the UCITS Directive.

²⁴ Art. 95 (a) AIFMD-CDR; ESMA 2011/379 page 169, Art. 6 UCITS-CDR.

²⁵ Ibid.

²⁶ Art. 95 (b) AIFMD-CDR; ESMA 2011/379 page 169, Art. 6 (b) UCITS-CDR.

²⁷ Recital 109 AIFMD-CDR and Recital 7 of UCITS-CDR.

Provided that when carrying out its duties on an ex-post basis, the depositary acts promptly to advise the investment manager and/or the management/investment company of a breach and obtain confirmation, when validated, of the correct measure, the depositary should be deemed to have adequately performed its oversight duties. Likewise, the investment manager and/or the management body should inform the depositary as soon as an investment breach (either passive or active) has been identified in the course of its review.

In case of disagreement on a breach analysis between the management/investment company and the depositary, the escalation process is applicable according to section VI hereafter.

In no circumstances shall the depositary be deemed to reverse a transaction that is in breach of those laws, regulations or rules, or to block a NAV calculation which would include this transaction.

TIMELY SETTLEMENT OF TRANSACTIONS

The depositary must ensure that, in transactions involving the fund's assets, any consideration is remitted to the fund within the usual time limits.²⁸ It should therefore:

- Set up a procedure to detect any situation where a consideration related to the operations involving the assets of the fund's is not remitted to the fund within the usual time limits, notify the management/investment company and, where the situation has not been remedied, request the restitution of the financial instruments from the counterparty where possible.²⁹
- Where transactions do not take place on a regulated market, assess the usual time limits with regard to the conditions attached to the transactions.³⁰

²⁸ Art. 21 (9) (d) AIFMD and Art. 22 (3) (d) of UCITS Directive.

²⁹ Art. 96 (1) AIFMD-CDR and Art. 7(1) of UCITS-CDR.

³⁰ Art. 96 (2) AIFMD-CDR and Art. 7(2) of UCITS-CDR.

Article 96 of the AIFMD-CDR and Article 7 of the UCITS-CDR require the depositary to detect any situation where the consideration for an investment transaction is not remitted to the fund within the usual time limits and escalate accordingly. Where the transactions do not take place on a regulated market,³¹ the commonly accepted time limits should be assessed with regard to the conditions attached to the transactions (OTC derivative contracts, investments in real estate assets or in privately held companies).³² To assess the usual time limit ESMA suggests referring to the relevant contracts by which the fund has secured its investment.³³

DISTRIBUTIONS OF INCOME

The depositary has to ensure that a fund's income is applied in accordance with the applicable national law and the fund rules or instruments of incorporation.³⁴

Article 97 of the AIFMD-CDR and Article 8 of UCITS-CDR clarify that this duty entails the following requirements:

- Ensure the net income calculation, once declared or distributed by the fund, is applied in accordance with requirements;
- Ensure appropriate measures are taken where the fund's auditor has expressed reserves on the annual financial statements. The management/investment company shall provide all necessary information on the expressed concerns, but depositaries will need to monitor auditor reports; and
- Check the completeness and accuracy of dividend payments, once declared or distributed, and, where relevant for AIF, of the carried interest.

The depositary's duties under Art. 21 (9) (e) AIFMD, and 22 (3) (e) of UCITS Directive in connection with Art. 97 AIFMD-CDR and Art. 8 UCITS-CDR are only triggered

³¹ Art. 50 (1) (a), (b), (c) and 8d) of UCITS Directive.

³² ESMA/2011/379 page 170.

³³ Ibid.

³⁴ Art. 21 (9) (e) AIFMD and Art 22 (3) (e) UCITS Directive.

once a decision has been made by the management/investment company to distribute.³⁵

Once the net income calculation is performed by the management/investment company itself or another entity appointed to provide that calculation (e.g. administrator), the depositary's role is to verify that appropriate measures were taken and, where it identifies an error, to ensure the management/investment company has taken appropriate remedial action.

Once it has ensured that appropriate measures were taken in regards to the net income calculation, it can verify the completeness and accuracy of the income distribution and of dividend payments.³⁶ The frequency of the checks should be proportionate to the frequency of the dividend declarations of the fund.

Furthermore, the depositary is expected to monitor that where auditors have expressed reserves on the fund's accounts, the management/investment company has taken appropriate measures to provide sufficient comfort to the auditors to ensure such reserves will not be reiterated.³⁷

CASH FLOW MONITORING

Monitoring of the fund's cash flows – Level 1 requirements

The depositary's cash monitoring function should be regarded as a general requirement to have a full overview of all cash movements of the fund which should be read along with the five oversight duties. Accordingly, the depositary must monitor the fund's cash flows. This monitoring function applies to all fund's cash flows (including cash flows resulting from subscription, redemption, corporate actions and transactions) rather than only in the context of subscriptions.³⁸ ESMA has recognised that the depositary is not "required" to make verifications along the fund distribution channel. It is a second-level control function to be carried out ex-post.

³⁵ ESMA/2011/379 page 171.

³⁶ Ibid; Recital 110 AIFMD-CDR.

³⁷ ESMA/2011/379 page 171.

³⁸ ESMA/2011/379 page 153.

Under the AIFMD-CDR and UCITS-CDR, the cash of the fund must be booked in one or more cash accounts opened in the name of either:

- The fund itself; or
- The management/investment company acting on behalf of the fund; or
- The depositary acting on behalf of the fund.³⁹

For AIFs, the cash account must be opened with an EU credit institution, a central bank or a non-EU authorised bank. For UCITS, the cash account must be opened with an EU credit institution, a central bank or another credit institution authorised in a third country provided that the prudential supervisory and regulatory requirements applied to credit institutions in that third country are considered by the CSSF as at least equivalent to those applied in the EU. Where the cash accounts are opened in the name of the depositary acting on behalf of the fund, no cash from the entity and none of the depositary's own cash shall be under any circumstance commingled.⁴⁰ The depositary shall, upon detection, report to the management/investment company any entity that does not meet the eligibility criteria.

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Cash monitoring - general requirements

As a prerequisite, it is required to ensure the depositary has access to all information it needs to effectively perform its cash monitoring functions.⁴¹ The management/investment company shall ensure that the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations.⁴² In order for the depositary to have a clear overview of all inflows and outflows of cash of the fund in all instances, the management/investment company should ensure that the depositary

³⁹ Art. 21 (7) AIFMD; see also Recital 37 AIFMD, and Art. 22 (4) (a) of UCITS Directive.

⁴⁰ Art. 21 (7) para 2. AIFMD and article 22 (4) para. 2 of UCITS Directive.

⁴¹ Cf. ESMA/2011/379 page 151.

⁴² Art. 85 (1) AIFMD-CDR and Art. 9 (1) UCITS-CDR.

receives without undue delay accurate information related to all cash flows, including from any third party with which a fund's cash account is opened.⁴³ Such information can be provided directly by the management/investment company or by any other entity appointed by the management/investment company to perform tasks which impact the depositary's function (e.g. prime brokers, third-party banks, administrators, investment managers etc.).⁴⁴

Monitoring of the fund's cash flows Level 2 requirements

The depositary shall ensure effective and proper monitoring of the fund's cash. In performing its cash flow monitoring duties, the depositary should:

- Ensure that all cash of the fund is booked in accounts opened with entities referred to in points (a), (b) and (c) of Article 18(1) of Directive 2006/73/EC in the relevant markets where cash accounts are required for the purposes of the fund's operations and which are subject to prudential regulation and supervision that has the same effect as EU law, is effectively enforced and is in accordance with the principles laid down in Article 16 of Directive 2006/73/EC;
- Implement effective and proper procedures to reconcile all cash flow movements and perform such reconciliations on a daily basis or, in case of infrequent cash movements, when such cash flow movements occur;
- Implement appropriate procedures to identify at the close of business day significant cash flows and in particular those which could be inconsistent with the fund's operations;
- Review periodically the adequacy of those procedures including through a full review of the reconciliation process at least once a year and

⁴³ Recital 97 AIFMD-CDR and Recital 9 of UCITS-CDR.

⁴⁴ ESMA/2011/379 page 151.

ensuring that the cash accounts opened in the name of the fund, in the name of the management/ investment company acting on behalf of the fund or in the name of the depositary acting on behalf of the fund are included in the reconciliation process;

- Monitor on an ongoing basis the outcomes of the reconciliations and actions taken as a result of any discrepancies identified by the reconciliation procedures and notify the management/investment company if an irregularity/discrepancy has not been rectified without undue delay and also the competent authorities if the situation cannot be clarified (For UCITS, the notification concerns the non-correction and not clarification) and, as the case may be, corrected;
- Check the consistency of its own records of cash positions with those of the fund. The management/ investment company shall ensure that all instructions and information related to a cash account opened with a third party are sent to the depositary, so that the depositary is able to perform its own reconciliation procedure.⁴⁵

In order for the fund's cash flows to be properly monitored the depositary's obligation consists of making sure that there are procedures in place and effectively implemented to appropriately monitor the fund's cash flows and that these procedures are periodically reviewed. In particular, the depositary should look into the reconciliation procedure to satisfy itself that the procedure is suitable for the fund and performed at appropriate intervals taking into account the nature, scale and complexity of the fund. The reconciliation procedure may in practice be maintained at the level of either the management/investment company and/or the appropriate delegate performing such function (transfer agents/fund administrators). Such a procedure may for example compare one by one each cash flow as reported in the bank account statements with the cash flows recorded in the fund's accounts.

⁴⁵ Art. 86 AIFMD-CDR and Art. 10 UCITS-CDR.

Another possibility is to perform a cash flow monitoring on all external and internal accounts and to compare the end-of-day balance of these accounts with the relevant balances mentioned in the NAV calculation. Where NAV calculations and reconciliations are performed on a daily basis as for most open-ended AIFs and for most UCITS, the depositary should perform its own reconciliation or ensure reconciliation is also done on a daily basis. The depositary should in particular monitor, based on aging and materiality criteria, the discrepancies highlighted by the reconciliation procedures and the corrective measures taken in order to notify without undue delay the management/investment company of any exceptions which has not been remedied. The depositary should also conduct a full review of the reconciliation procedures. Such a review should be performed at least once a year. The depositary should also identify on a timely basis significant cash flows and in particular those which could be inconsistent with the fund's operations, such as changes in positions in fund's assets or subscriptions and redemptions, and it should receive periodically cash account statements and check the consistency of its own records of cash positions with those of the management/ investment company. The depositary should keep its record up to date in accordance with Article 21(8)(b) of Directive 2011/61/EU and Article 22 (5) (b) of Directive 2009/65/EC.⁴⁶

It will be essential for the depositary to receive without undue delay all relevant information from the management/investment company or any third party (administrator, investment manager etc.). Information protocol will need to be implemented as well as procedures and processes to ensure timely and effective monitoring of the fund's cash flows.

⁴⁶ Recital 98 AIFMD-CDR and Recital 10 UCITS-CDR.

a) Key principles

The key principles around the new cash monitoring duties required under the AIFMD-CDR and UCITS-CDR are the following:

- Set up effective exchange of information between the depositary and the management/investment company and/or its delegates or counterparties in relation to the cash account documentation (initial and ongoing reporting).
- Set up controls that enable the depositary to:
 - Perform the reconciliation of the fund cash flows either through adequate reviews of the reconciliation process that is already in place or a monitoring of flows using, where they exist and are deemed appropriate by the depositary, administrators' processes (internal fund accounting and/or transfer agents or external trusted service providers)⁴⁷ or via duplication of the cash flows reconciliation.
 - Identify and report significant cash flows based on materiality and the nature and source of the transactions.

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b) Clarifications/interpretations

The provisions on the cash monitoring raise several questions and require detailed clarifications and appropriate interpretations on the practical rules that need to be implemented, and shall, among other areas include the following key areas:

- i. Subscription payments monitoring duties through reconciliations of “collection accounts”;⁴⁸
- ii. Look-through considerations for specific AIF types (for example private equity funds, real estate funds);
- iii. Models to meet the obligation on cash flow reconciliation;
- iv. Cash margin carried out by the fund with an intermediary (e.g. brokers, OTC derivative counterparties);

⁴⁷ Trusted external service providers are providers that meet sufficient quality, reporting and responsiveness criteria.

⁴⁸ A collection account is an account opened in the name of entities such as alternative investment fund managers (AIFMs), UCITS management companies, UCITS, AIFs or service providers including administrators, custodians or transfer and registration agents. Collection accounts include subscription monies received before they are transferred to the fund, redemption proceeds after they have been paid out of the fund and dividends which have left a fund but have not yet been paid to investors.

1. Subscription payments monitoring duties through reconciliations of “collection accounts”.

The depositary is also required to ensure that payments made by investors upon subscription have been received by the fund. Regarding AIFs, ESMA's advice clarifies that the depositary is not expected to interfere with the distribution channels of the AIF but simply to verify the information at the level of the AIF's register.⁴⁹ In accordance with Art. 87 of the AIFMD-CDR and Article 11 of UCITS-CDR, depositaries should pay particular attention on the proper settlement of subscription payments. For the purpose of meeting its monitoring obligation, the depositary will need to review the set-up of collection accounts. Collection accounts are opened in the names of various owners.

They may be opened for several funds (grouped by umbrella, by management/investment company or by any other criteria). The depositary may fulfil its subscription monitoring duties through the use of reconciliations carried out by the administrative agents (transfer agents/fund administrators).

Cash accounts within/relating to the distribution channel shall be excluded from the depositary's monitoring duty. The information on subscriptions from transfer agents at the collection account level is the lowest level that a depositary is required to monitor in order to adequately fulfil its duties on subscription monitoring.

As part of its oversight duties on subscriptions and redemptions, the depositary will also be in charge of the following oversight duties:

- Due diligence over the transfer agent;
- Control on shares/units issued (comparison between fund administration and transfer agent records); and
- Review exception reports produced by the transfer agent (based on materiality rules).

2. Look-through considerations for Private Equity and Real Estate (PERE) funds

Article 86 of the AIFMD is entitled “Monitoring of the AIF's cash flows” and thus all requirements in subsections a) to f) should be understood with reference to cash accounts held at the level of the AIF only. The cash falling under

⁴⁹ ESMA/2011/379 page 137.

the scope of the AIFMD is either cash credited on a cash deposit account opened in the name of the fund, or a cash deposit account opened in the name of the management/investment company for the fund, or a cash deposit account opened in the name of the depositary on behalf of the fund. Conversely, cash deposit accounts opened in the name of other entities do arguably not fall within the scope of the cash flow monitoring duty even if said entities are controlled by the fund such as special purpose vehicles (“SPVs”).

Article 86 (d) of the AIFMD-CDR dealing with the depositary review of its reconciliation procedures clarifies that the cash flow reconciliation process refers to accounts opened in the name of the AIF, AIFM acting on behalf of the AIF, or depositary acting on behalf of the AIF.

Where the “look-through” concept applies, it is only in respect of safekeeping duties and not in relation to a depositary’s other obligations under the AIFMD. This means that depositary duties such as cash monitoring would not apply in respect of the assets of the underlying fund/SPV, unless specific arrangements have been agreed for this scope.

3. Models to meet the obligation on cash flow reconciliation

For the purpose of complying with the obligation on cash flow reconciliations, the depositary may consider the following arrangements:

- The institution, providing depositary services, also acts as administrative/transfer agent which in its capacity undertakes cash flow reconciliations (fund administrator, middle office and/or the transfer agent regarding collection accounts).
- When the depositary does not undertake cash flow reconciliations, it may use the cash flow reconciliation performed by a third-party service provider, provided that the depositary obtains all information and exception reports it needs to comply with its own cash monitoring, and has performed a successful due diligence of the reconciliation process performed by such service provider (e.g. fund administrators). In the latter case, the depositary should focus its monitoring duties on unmatched and aged items identified at each cash reconciliation process, ensuring thereby that significant exceptions are properly investigated.

- If the depositary is not in a position to implement an adequate control plan (effective and reliable) with the “internal” or “external” service provider, it shall undertake the whole process by itself.

When assessing whether or not cash flow reconciliations are properly performed within the spirit of the AIFMD and UCITS, the depositary shall:

- Be satisfied on the ongoing effectiveness of the reconciliation process and be able to receive all required information from any third party involved (fund administrators, transfer agents, banks holding cash, etc.).
- Assess the cash flow reconciliation process on an independent basis.
- Undertake an appropriate second level of control on the cash flow reconciliations performed by any third-party entity.

It is understood that the depositary’s responsibility as defined in the AIFMD and UCITS Directive clearly remains unchanged regardless of the method adopted by the depositary to monitor cash flows.

4. Cash margin accounts held by the fund with an intermediary (e.g. brokers, OTC derivative counterparties)

Cash accounts falling under the scope of the cash flow monitoring duties do not include cash collateral/margin accounts, held at clearing brokers, CCPs and OTC derivative counterparties. The depositary should also conduct ex-post monitoring of collateral/margin cash accounts reconciliations basing itself on the broker statements received from the brokers involved or reconciliations carried out by the administrative agent as required under point 71 b) of CSSF Circular 16/644.

OVERSIGHT DUTIES – METHODOLOGY

General principles:

1. In order to perform its oversight duties, the depositary must perform a risk assessment of the fund investment strategy and its internal control framework at the management/investment company and/or its delegates
2. The depositary will establish its ongoing monitoring process by defining the periodicity of its controls based on its risk assessment which includes the complexity of the fund, the NAV frequency, any eventual issues detected in the past and the outcome of the due diligence performed on the management/investment company and its delegates (where applicable).
3. In order to implement its ongoing monitoring process, the depositary will establish together with the management/investment company and relevant delegates the operating model and the set of information to be exchanged so that the depositary is capable to perform its fiduciary activities – in the form of an operating memorandum/service level agreement or similar document.

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In accordance with the regulatory framework under the AIFMD and UCITS Directive, the depositary has to ensure that procedures and processes are implemented and appropriately applied at the level of the management/investment company and/or relevant delegates (as may be applicable).

The management/investment company shall ensure that upon commencement of the depositary's oversight duties and on an ongoing basis, the depositary is provided with all relevant information it needs to comply with its obligations, including information to be provided by their delegates such as transfer agents, fund administrators, investment managers, and external valuers, if any.

The depositary will have to undertake initial and periodic assessments of the risks associated with the nature, scale and complexity of the fund's strategy. It will need to complement its assessments by performing reviews of the activities of the management/investment company and their relevant delegates (as may be applicable) to define its oversight programmes and procedures.

From this initial assessment and applying a risk-based approach, the depositary will decide on the level of due

diligence it needs to implement and the number and type of periodic controls it needs to undertake. The depositary may also be required to perform additional reviews of tasks performed by the management/investment company and their delegates if irregularities are detected.

■ Oversight of management and administrative activities

Within the remit of its scope of activities the depositary is responsible for verifying that a fund is managed in accordance with the provisions of its constitutional documents (articles of incorporation for an investment company, management regulations for an FCP) and its prospectus rules. The management/investment company must advise its depositary with sufficient time in advance of any modifications to the fund's offering documents (e.g. on the fund's prospectus in case of material amendments like the appointment of new service providers, new investment policies, new markets, etc.).

In order to fulfil each specific oversight duty, the depositary has the opportunity to design a set of programmes by selecting a number of proposed controls over the activities of the fund, which may include amongst others:

- A review of the implementation and the proper application of policies and procedures of the management/investment company and/or delegates.
- Copy of long-form report and management letter (for the parts that are of relevance for the performance of the depositary activities and if applicable) to be provided to the depositary.
- Copy of the audited annual financial statements.
- A review of external audited reports (ISAE 3402 type 2, AT 801 type 2, or equivalent reports).
- Periodic controls of performance and exception reports from the management/investment company and/or delegates.
- Due diligence (including, as the case may be, on-site visits) on service providers engaged in the fund's operations (questionnaire, sample checks of processes).
- For investment instructions, ex-post checks to verify the compliance of the fund with applicable law and regulations, the fund rules and instruments of incorporation.

DUE DILIGENCE ON THE ManCo/ AIFM, THE FUND OR THEIR DELEGATES

The due diligence plan and frequency will be based on the initial assessment made by the depositary of the risks associated with the fund's strategy and the organisation of the management/investment company and/or its delegates. In principle, a due diligence on management/investment company and/or its delegates is conducted once a year or at a frequency decided by the depositary following the initial assessment. At every due diligence, the depositary will reassess the level and/or frequency of the due diligence and adjust the next one where relevant.

The risk assessment shall also take into account information gathering through the review of exceptions noticed in the fund long form report and management letter, in the external audited report management/investment company's delegates (ISAE 3402 Type 2 or equivalent).

Questionnaire

In order for the depositary to oversee that adequate procedures and controls are in place it may make use of due diligence questionnaires.⁵⁰

In May 2015, ALFI published a framework for due diligence information packs which seeks to provide a table of contents/headings upon which service providers (delegates) to which a fund board, ManCo or AIFM has delegated activities and services can base their preparation of documentation required to support the initial and ongoing due diligence reviews of a fund and/or its ManCo under Luxembourg regulations. Despite the fact that the proposed due diligence information packs are for boards of Luxembourg funds, management companies and AIFMs to facilitate initial and ongoing due diligence reviews on their delegates, the following sections may also help depositaries to organise their own due diligence reviews:

- General information, business operating model, technology/systems, etc.;
- Transfer agency;
- Fund administration.

⁵⁰ <http://www.alfi.lu/sites/alfi.lu/files/Framework-for-Due-Diligence-Information-Pack-final.pdf>.

The table of contents and headings may not be suitable for every circumstance and are not exhaustive; therefore depositaries may have to adapt and broaden the scope of information and/or request more granular information based on their particular areas of focus. For example, depositaries may have to broaden the scope of due diligence information on management companies and AIFMs when it relates to portfolio management and risk management.

On-site visits

The depositary may also decide to perform on-site visits on the management/investment company and its delegates.

The depositary may make use of on-site visits to

- Clarify open questions;
- Receive a deeper insight for processes and controls (to the extent such processes and controls relate to depositary duties);
- Receive insight in internal documents and reports.

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PERIODIC CONTROLS – EXCHANGE OF INFORMATION/REPORTS

The depositary needs to have access to all necessary information and data to perform and fulfil its fiduciary activities. For that purpose, the management/investment company and/or delegates will ensure that the depositary receives all relevant information, including tools and reports of their delegates.

Review of controls

If the depositary identifies serious or repetitive weaknesses in the organisation of the management/investment company or one of its delegates which are or could be detrimental to the investors of the fund, it can decide, after proper notification to the management/investment company, to increase the number of controls or arrange for deeper reviews of certain processes that have or might have caused financial impacts.

Notwithstanding the above, the depositary may undertake to perform a control at any time within the period in accordance with its internal control policy.



LIST OF PROPOSED OVERSIGHT DUTIES AND CONTROLS AND FREQUENCY OF CONTROLS

DUTIES REGARDING SUBSCRIPTIONS AND REDEMPTIONS

Initial and periodic assessment of policies and procedures

Via the due diligence process, the depositary shall verify that adequate procedures and policies have been set at least for:

- Unit/share contractual and cleared funds settlement procedures.
- Unit/share dealing price provided by the fund administrator.
- Reconciliation of the total number of units/shares issued or redeemed and the subscription or the redemption proceeds received or paid.
- Reconciliation by the fund administrator of the number of units/shares in the fund accounting records and the number of units/shares in the register (could also be included in the oversight of the calculation of the value of units/shares).
- The issuing of accurate contract notes and statements of holdings to the fund's unitholders/shareholders.
- The maintenance of the unitholders'/shareholders' register.
- AML/KYC requirements.
- Specific conditions as outlined in the fund's constitutional documentation.
- Measures to protect funds and investors from market timing and late trading.

Periodic controls

In line with its initial assessment, the depositary shall undertake periodic – sample – checks of the reports received from the transfer agent with regards to:

- Aged and material unreconciled items of collection accounts with the status and explanations of outstanding breaks.
- Errors identified in the dealing activity.
- Reconciliation by the fund administrator of the number of units/shares in the fund accounting records and the number of units/shares in the register (could also be included in the oversight of the calculation of the value of units/shares).
- Incorrect amount paid or received to or from unitholders/shareholders.
- Payment of compensations as specified in remedial action plans (actions taken by the management/investment company as required under CSSF Circular 02/77).
- Sample checks to ensure late trading and AML/KYC processes are properly implemented and controlled at the level of the management/investment company and/or its transfer agent.

Frequency of controls

In principle, the frequency of the depositary's checks should be proportionate with the frequency of subscriptions and redemptions. As such the depositary may not solely rely on auditors' reports in this context. As an indicative example, the depositary could undertake the following reviews for funds transacting on either a daily or weekly basis:

- Initial and periodic reviews of implemented/updated procedures and policies.
- Periodic reviews at a frequency commensurate with the valuation frequency of the fund (weekly for daily valued funds etc.) of aged and material unreconciled items of collection accounts and monthly checks of other

exceptions reports prepared by the transfer agent or another of the delegates of the fund.

- Due diligence (including as the case may be on-site visits).

If a fund is transacting its units/shares on a less frequent basis, the depositary may adapt the frequency of the proposed checks.

DUTIES REGARDING THE VALUATION OF SHARES/UNITS

Initial assessment

The depositary shall verify that adequate procedures and policies have been set for:

- The valuation of financial instruments and other assets (including derivatives, physical assets, loans, real estate, shareholding interests, etc.).
- Reconciliations of statements against the fund accounting records, e.g.:
 - Financial instruments and other assets;
 - Derivatives;
 - Shares/units issued by the fund;
 - Income/tax accrual review.
- Expense accrual and payment recording, including performance fees.
- NAV validation and units/share price movement review.
- Application of materiality thresholds as defined by the regulator.
- Swing pricing.

Periodic controls

The depositary shall consider and be able to rely on periodic reports produced by the management/investment company, the administrative/accounting agent and the external valuer (AIF) with regards to:

- Aged and material unreconciled holdings (cash, securities, corporate actions, investment incomes and derivatives);

- Sample checks on stale prices, suspended/unquoted securities, exceptional price movements in the market as well as any issues which may impact the valuation of the assets of the fund;
- Checks covering performance fees, expense accruals, accrued income and any other position impacting the NAV.

In accordance with CSSF circular 02/77, the depositary will have to be made aware of any material NAV error at the same time the exception is reported to the CSSF.

It is important to recall that the CSSF clarified its position on the application of Circular 02/77 to Specialised Investment Funds (SIF) in its Annual Report 2013 and considers that any NAV calculation error as well as any instance of non-compliance with investment rules by a SIF must be subject to a notification to the CSSF, whether the SIF chose to apply Circular 02/77 or to set other specific internal rules.

If the depositary identifies serious or repetitive weaknesses in the organisation of the management/investment company or one of its delegates which could be detrimental to the investors of a fund, it can decide, after proper notification to the management/investment company, to increase the number of controls or arrange for deeper reviews of certain processes that have or might have caused financial impacts.

Frequency of controls

In principle, the frequency of the depositary's checks should be proportionate to the frequency of NAV calculation in the context of share transactions.

As an indicative example, the depositary could undertake the following reviews for funds calculating their NAVs on a daily or weekly basis:

- Initial and periodic reviews of implemented/updated procedures and policies;
- Monthly checks of exceptions reports received by the administrator/accounting agent;
- Due diligence (including as the case may be on-site visits).

If the NAV of a fund is calculated on a less frequent basis, the depositary will adapt the frequency of the proposed checks.

If the depositary identifies serious or repetitive weaknesses in the organisation of the management/investment company or one of its delegates which could be detrimental to the investors of a fund, it can decide, after proper notification to the management/investment company, to increase the number of controls or arrange for deeper reviews of certain processes that have or might have caused financial impacts.

DUTIES REGARDING THE CARRYING OUT OF THE FUND'S INSTRUCTIONS

Initial and periodic assessment of policies and procedures

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The depositary will apply controls proportionate to the risk assessment of the types of assets (transferable securities, financial instruments, unlisted securities, physical assets, etc.) the fund will invest in.

For the purpose of monitoring compliance with the fund's rules and statutory restrictions, the management/investment company will ensure that the depositary receives all relevant reports in order to comply with its obligation pursuant Article 95 AIFM-CDR and Article 6 UCITS-CDR including reports of third parties appointed by the management/investment company, so that the depositary can verify that adequate controls are in place.

Periodic controls

As part of its periodic controls the depositary has to verify on an ex-post basis, the compliance of the fund with applicable laws and regulations and the fund's rules and instruments of incorporation. In this context, ex-post is to be understood as post transaction and NAV calculation. The periodic controls may require the depositary to perform compliance checks itself or controls on the accuracy of the ex-post compliance checks performed by a third party appointed by the management/investment company. It is assumed that as a prerequisite prospectus requirements must be technically and legally enforceable.

The depositary could also consider periodic reports produced by the management/investment company, the investment manager or a third party appointed by the management/investment company with regards to identified compliance breaches.

In accordance with CSSF Circular 02/77, the depositary will have to be made aware of any active breach at the same time the exception is reported to the CSSF.

It is important to recall that the Commission de Surveillance du Secteur Financier (CSSF) clarified its position on the application of Circular 02/77 to Specialised Investment Funds (SIF) in its Annual Report 2013 and considers that any NAV calculation error as well as any instance of non-compliance with investment rules by a SIF must be subject to a notification to the CSSF, whether the SIF chose to apply Circular 02/77 or to set other specific internal rules.

For very particular or complex investment strategies (e.g. sharia-compliant funds,⁵¹ use of securitisation, limits applicable to underlying investments), the depositary is not always able to monitor the legality of the investments by itself. In this context, the depositary will ensure that it may rely on controls that have been performed by the management/investment company, the investment manager or a third-party provider appointed by the management/investment company. As reminder, the task of the depositary is to oversee the monitoring of investment rules by the management/investment company of the fund or its delegate and to ensure that the investments meet the requirements designed by the investment manager, not to act as adviser to the fund nor judge the potential merits of an investment.

The depositary may have to rely on figures and information provided by third parties and shall not be responsible for the accuracy of such figures and information.

⁵¹ For further information please refer to the ALFI Guidelines - Islamic funds - Collection of best practices for setting-up and servicing Islamic funds.

Specific considerations

Private equity and real estate – AIFs investing in targets through SPVs

Although the AIFMD solely requires all oversight duties and cash flow monitoring to be performed at the level of the AIF, the depositary should have an understanding of the full AIF's structure and ensure that any investment made at the level of SPVs meets the investment objectives of the fund.

Collateral/margin rules

ESMA Guidelines on ETFs and other UCITS issues

In addition to the rules and requirements set out in the UCITS Directive, depositaries need to ensure that UCITS also comply with the specific rules and requirements of the ESMA Guidelines on ETFs and other UCITS issues when they enter into OTC financial derivative transactions and efficient portfolio management techniques.

EMIR margin rules for uncleared OTC derivatives

On 4 January 2017, new EU regulatory technical standards under the European Market Infrastructure Regulation (EMIR) came into force and require parties to uncleared OTC derivatives to exchange variation margins and largest market participants to exchange initial margins.

Depositaries, for both AIFs and UCITS, need to include in their controls the collateral diversification rules (eligible collateral, credit quality and concentration limits).

Clarifications on “collateral safekeeping arrangements” will be detailed in separate guidelines on in-bank assets.

Frequency of controls

The frequency of the depositary's checks should be proportionate and related to the frequency of the NAV calculation of the fund and the results of the initial risk assessment.

At least on a monthly basis or at each valuation point if the NAV of the fund is calculated at a lower frequency, the depositary will perform investment compliance checks or a review of investment compliance checks performed by the third party appointed by the management/investment company to perform such checks. Nevertheless if the depositary identifies serious or repetitive weaknesses in the organisation of the management/investment company or one of its delegates which could be detrimental to the investors of a fund, the depositary can decide to increase the number of controls or arrange for deeper reviews of certain processes that have or might have caused financial impacts.

Notwithstanding the above, the depositary may undertake to perform a control at any time in accordance with its internal control policy.

DUTIES REGARDING THE TIMELY SETTLEMENT OF TRANSACTIONS

The depositary shall follow market settlement practices in order to detect, handle and mitigate risks associated with unmatched trade and settlement anomalies when the remittance of the consideration deriving from a fund asset transaction is (i) delayed (i.e. effected after the usual time limits) or (ii) totally missing. It shall be noted that this duty is also performed by the depositary as part of the day-to-day administration of unprocessed and unmatched trades and ownership verification of the fund's assets.

As such the depositary is reliant on information received from its delegates and/or the management/investment company.

For the sake of clarity, “transactions” to be timely settled within the meaning of Article 96 AIFMDCDR and Article 7 of the UCITS-CDR relate to the purchase and sale of

fund's assets and more generally any transaction where cash monies, securities or other assets have to be remitted as a consideration. Depositary duties regarding the timely settlement of transactions can be classified under the following categories:

- i. Time limits with respect to transactions on regulated markets;
- ii. Time limits regarding transactions outside a regulated market (that may be fully left to the trading counterparties, hence a need to inform the depositary of the settlement cycle envisaged so as to perform transactions in due time);
- iii. Frequency of controls.

The AIFMD and UCITS Directive adopted an asset-classification approach whereby assets entrusted to the depositary are divided in two different categories:

- i. Financial instruments of the fund that can be held in custody, and
- ii. All other assets, i.e. those that do not fall within the first category.

Transactions taking place on a regulated market (financial instruments)

The depositary will verify that settlement is effected in accordance with local market trade cycle. The depositary will ensure that where part or all of its safekeeping duty in relation to financial instruments is delegated to a third party, such delegate has the relevant means to identify and repair any failed transactions.

To monitor the remittance of transactions, the depositary shall for instance require the delegate:

- To provide all trade confirmations of transactions in a timely manner and to be notified or have access to any relevant information to properly settle transactions and other operations for the fund;
- To provide documentation detailing settlement procedures according to market practice (type of settlement, DVP, remittance time) taking into account the type of instruments.

The depositary shall review unsettled trade records against the expected timeframe set in the procedure. To do so, the depositary may consider establishing thresholds based on age and materiality of exceptions to filter and flag overdue trades requiring further investigations.

The depositary shall ensure that there are mechanisms in place to validate the information associated with the trade and monitor its status to ensure potential issues are escalated and resolved in a timely manner.

Transactions in financial instruments not dealt on a regulated market and transactions in other assets

The usual time limits shall be assessed with regard to the conditions attached to the transactions (OTC derivative contracts or investments in real estate assets or in privately held companies).

The depositary is dependent on receipt of accurate and timely asset-related information from a variety of third parties. The depositary does not control registrations and title transfers involving assets not held in custody and must rely on information flows and records maintained by unrelated third parties to provide recordkeeping services. The depositary will have to rely on information provided by the management/investment company to perform its duty and the concept of "usual time limits" will vary depending on numerous parameters.

Frequency of controls

The frequency of the depositary's checks should be proportionate and related to the frequency and type of trading activity of the fund. For example, significant transactions outside regulated markets may require a prompt review while monthly summary reports of significant late settlement may be sufficient in the case of securities transacted on regulated markets.

DUTIES RELATED TO THE FUND'S INCOME DISTRIBUTION

Initial and periodic assessment of policies and procedures

The depositary shall verify that adequate procedures and policies have been set in accordance with the fund's constitutional documents for:

- The required approval as stipulated in the fund's constitutional documents of any income distribution from the board of directors;
- The proper calculation of the income distribution;
- Records of distribution payments in the books of the transfer agent and the fund administrator, including associated control environments;
- Timely communication of the distribution to unitholders/shareholders;
- Treatment of unclaimed distributions.

Note that the review should not be limited to income distributions but also include capital distributions (mostly to check if it is authorised or not as some funds may not distribute capital).

Periodic controls

The depositary shall perform its periodic controls at least by obtaining reports or relevant parts of the long-form report and supporting documents from the management/investment company or its delegate. The depositary may also perform on-site visits on the transfer agent and/or the fund administrator.

In carrying out its oversight duties over the income distribution process, the depositary shall consider performing the following controls:

- Review procedure updates;
- Request on an ex-post basis the list of resolutions of the board of directors and/or decisions taken by shareholder meetings on dividend distributions and check if dividends were declared during the period under review and verify adherence to the terms for

dividend distributions as defined in the constitutional documents of the fund. The depositary can rely on the figures provided by the management/investment company and/or the fund administrator as the depositary is not required to recalculate the income of the fund.

- Consult records for dividend distributions at the transfer agent of the fund; perform sample checks of payments and reinvestments, and cross-check consistency with board and/or unitholder/shareholder decisions as well as the instructions received from unitholders/shareholders.
- Review newly identified unclaimed dividends, and follow up on aged and unclaimed dividends identified during previous reviews.
- When there is an issuance of a qualified audit opinion, verify that the corrective action to prevent recurrence has been implemented by the management/investment company or its delegate.

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Frequency of controls

The frequency of the depositary's checks should be proportionate and related to the frequency of the dividend declarations of the fund. For example, yearly dividends could be covered through annual reviews. Where the intervals are shorter, quarterly reviews could be considered.

CASH MONITORING

Principles

Under the AIFMD-CDR⁵² and the UCITS-CDR, the depositary is required to implement a new set of obligations, implying more practically the obligation to:

1. Have a comprehensive view and maintain an up-to-date list of all cash accounts of the fund;
2. Ensure that all the cash has been booked with eligible entities, i.e. subject to sufficient level of supervision;
3. Implement procedures to review the reconciliation of all cash flows;

⁵² Article 86 of the Delegated Regulation, AIFMD-CDR and Article 10 of the Delegated Regulation of UCITS-CDR.

4. Identify significant and inconsistent cash flows;
5. Ensure irregularities identified in the reconciliation process are properly and timely rectified; and
6. Review periodically the adequacy of the procedures related to the previous items.

Proposed methodologies and controls

In order to fulfil its obligations, the depositary may implement the following methodologies and controls:

1. Maintain an up-to-date record of existing cash accounts of the fund held by eligible banks and credit institutions:
 - Initially and on an ongoing basis, the management/investment company and/or relevant appropriate delegate or counterparty in relation to the cash account documentation should confirm the full list of cash accounts of the fund (accounts held by or in the name of the fund) and inform the depositary about any new account prior to opening.
 - The information to be provided to the depositary shall include, at a minimum:
 - The list of cash accounts;
 - Balances and cash movements of every account.
 - The management/investment company and/or relevant delegate shall require the third party with whom an account is opened to provide the depositary with all necessary information and data on a timely basis.
 - The depositary will maintain an up-to-date list of cash accounts according to the information received.
2. Ensure all cash of the fund has been booked with eligible entities.

In addition to the task performed under item (1), the depositary will have to assess whether or not each third party falls under the eligibility criteria and is submitted

to a level of supervision which has the same effect as EU law. For that purpose, the depositary may adopt the following approach:

- If the country of the third party is part of the OECD, the principle of equivalence in terms of the supervision level and the efficiency of enforcement is acceptable.
 - The depositary may also accept, on a case by case basis, an entity established in non-OECD countries as long as the eligibility criteria and supervisory framework applicable to this entity are equivalent to the EU rules and requirements.⁵³
 - To complete its review, the depositary may benefit from the assessment undertaken by the management/investment company.
 - If the depositary remains uncomfortable with the regulatory framework of the country where the credit institution or bank is established, it will have to raise its concerns in accordance with the escalation process described in Section VI – Escalation process.
3. Perform an independent control on cash flow reconciliations:⁵⁴

For all fund's cash accounts opened in the name of fund, the depositary has to establish procedures to reconcile cash accounts or to review procedures of the reconciliation process at the level of the management/investment company, a delegate like the fund administrator, a collateral manager or any other counterparty involved in the reconciliation process.

- Depending on the organisation, the depositary may choose to implement Model 1 if the cash flow reconciliations are performed directly by itself, otherwise Model 2 might be implemented (see Appendix 1 for

⁵³ The CSSF considers the following countries, outside of OECD, as supervision-equivalent: Guernsey, Jersey, Liechtenstein, Singapore and Hong Kong. Considering that the UCITS-CDR provides that the prudential supervisory and regulatory requirements applied to credit institutions in third countries shall be considered by the competent authority of the UCITS home member state as at least equivalent to those applied in the EU, the CSSF can be requested to determine the equivalence status of other third countries.

⁵⁴ This section refers to two possible models. It should be noted that each model needs to be amended to the specific set-up, requirements and circumstances. Other models than the ones described above are possible as well.

description of Model 1 and Model 2). For any model (Model 1, Model 2 or any other possible model), the depositary will review the exceptions and investigate for a proper justification and adequate follow-up after having applied appropriate thresholds based on amounts involved and/or duration of the exception. The depositary does not investigate open items on its own but will ensure to receive a satisfactory explanation of outstanding items from the fund management/ investment company or the fund's delegate (fund administrator or transfer agent) in charge of the reconciliation.

- If the depositary identifies exceptions that cannot be adequately justified, it will have to raise its concerns in accordance with the escalation process described in Section VI – Escalation process.
- The frequency of reconciliation should be at a minimum at each NAV frequency.

4. Identify significant and inconsistent cash flows:

- “Significant” implies a concept of materiality and means cash flows that exceed certain thresholds (absolute amounts in a certain currency and/or a percentage of the NAV). These thresholds have to be proportionate to the nature of the operation (e.g. delivery versus payment (DvP) transactions or not), the source of the transaction (secured source or not), the counterparty (counterparty often used or not), the investment policy of the fund (e.g. securities only, private equity, real estate), if it is a transfer in or out etc.
- We should consider cash flows as “inconsistent” if they are not in line with the expected activities of the fund. In order to detect such movements, the depositary should be particularly watchful about cash movements
 - that are non-DvP;
 - implying unknown counterparties;
 - not issued from a secured source or well-known system;
 - without properly documented economic reason;
 - not resulting from the fund activity.

- When a significant and potentially inconsistent cash flow is found, the depositary will use all available information from custody, fund administration or transfer agent services and the management/investment company or, when required, from third-party banks in order to obtain a proper justification together with the relevant supporting data and information. Where rectification is required the party in charge of the rectification process will provide the course of action to amend the transaction in the best interest of the fund/investors in a timely manner.

In the absence of proper justification, the depositary will have to raise its concerns in accordance with the escalation process described in Section VI – Escalation process.

5. Review periodically the adequacy of procedures:

The depositary will review its own internal control framework and the internal control framework of the management/investment company and/or of its delegates (cf. details in Section III – Oversight duties and methodology) to ensure their cash-related procedures are satisfactory.

UCITS SPECIFICITY - COMPLIANCE WITH CSSF CIRCULAR 16/644 WITH REGARD TO THE MANAGEMENT OF COLLATERAL

Under CSSF Circular 16/644, depositaries are requested to adopt specific organisational arrangements with regard to guarantees or sureties.

In particular, when guarantees or sureties are put in place for the benefit of the UCITS (be it in the form of a transfer of the legal ownership or by means of a pledge), the depositary is obliged to verify that the sureties to be received comply with the legal and regulatory provisions in force, taking into account particularly the rules contained in CSSF Circulars 13/559 and 14/592 implementing the ESMA Guidelines on ETFs and other UCITS issues (2014/397) and especially their provisions relating to the management of collateral for OTC financial derivatives transactions and efficient portfolio management techniques.

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Such provisions define among other things the various criteria all collateral used to reduce counterparty risk exposure should comply with at all times where a UCITS enters into OTC financial derivatives transactions and efficient portfolio management techniques, in particular:

- The minimum collateral requirements considering counterparty risk limits (Article 52 of the UCITS Directive) and the use of so-called haircuts;
- The eligibility of assets received as collateral, which must be assessed in terms of liquidity, valuation, issuer credit quality and correlation;
- Additional requirements which apply in terms of collateral diversification/concentration, safekeeping of collateral received, and reinvestment of non-cash collateral received;
- The disclosure requirements in the annual report and in the prospectus of the UCITS.

Considering that:

1. According to CSSF Circular 14/592, “the management of the risks linked to the collateral must be part of the risk management function of management companies and Self-Managed SICAVs” and
2. According to CSSF Circular 16/644, the depositary shall perform its duties “without prejudice to the responsibility of the UCITS in the matter” and is only requested to “verify”,

it is understood that at the level of the depositary:

1. The obligation is of the same nature as the oversight duties assigned to the depositary, which the depositary is deemed to satisfy by performing ex-post controls and verifications of processes and procedures that are under the responsibility of the UCITS or, as the case may be, its management/investment company or an appointed third party;
2. The depositary can consequently validly discharge itself of its obligations in such context by ensuring that the management/investment company has effectively implemented a risk management framework which covers the management of collateral in compliance with the aforementioned regulation.

To that end, the depositary may assess the control framework implemented by the management/investment company at the time it is requested to assess the risks with the organisation of the management/investment company (see Article 3.1, chapter 2 of Commission Delegated Regulation (EU) 2016/48 of 17 December 2015). As part of such due diligence, the risk management process implemented by the management/investment company as a requirement of CSSF Circular 11/512, will in particular provide the depositary with information in relation to the methods used by the UCITS for the determination and monitoring of the counterparty risk arising from techniques and instruments (efficient portfolio management), and the policy in relation to

the collateral (definition of eligible collateral, collateral management, discounts, monitoring of collateral, allocation of responsibilities with respect to management and monitoring of collateral, etc.) used for mitigating counterparty risk linked to these transactions. In addition, the results of the controls performed by the management/investment company or its delegate, may be obtained by the depositary (on a periodic basis or on an exception basis) in order to verify the proper performance of the controls.

Depositary limits of responsibility

For the sake of clarity, from a regulatory point of view, the depositary is:

- Neither responsible for controlling the proper calculation by clearing houses (based on market rules and sophisticated algorithms) or counterparties/collateral managers (based on contractually agreed rules) of collateral amounts or (initial and/or variation) margin deposits that are called,
- Nor for acting in a situation of overcollateralisation with a counterparty. In fact the decision to leave with a counterparty (or a collateral agent) collateral assets in excess of what is required in relation to existing AIF/UCITS exposures lies solely with the AIF/UCITS or its management/investment company as it is to be considered as an act of management dealing with counterparty risk which is borne by the AIF or UCITS.

ESCALATION PROCESS

The depositary will need to put in place clear and comprehensive escalation procedures including a series of steps which would assist the depositary in the monitoring of identified issues or errors until their timely resolutions.

The depositary will promptly escalate any weakness, issue or error/breach identified during its due diligence and verification reviews to the conducting officers and/or the compliance officer, or any other appropriate and approved senior person of the management/investment company in charge of these tasks or associated controls. The depositary should maintain a record of all identified weaknesses, breaches and errors (audit trail), confirming their accuracy and resolution, and where compensation is due, ensure confirming that compensation has been paid to injured fund and/or its investors within a reasonable period of time.

Page 28 Any aged outstanding items are to be escalated to the board of the management/investment company and/or any authorised representatives. Regardless of the activities performed by the depositary, the management/investment company remains responsible for oversight of actions carried out by its delegates and has to deal with issues identified and settle them in the best interest of its investors.

In accordance with the provisions of CSSF Circular 02/77, the management/investment company will ensure that the depositary receives all notifications of material NAV errors and active breaches at the same time the exception is reported to the CSSF.

If the depositary identifies serious or repetitive weaknesses in the organisation of the management/investment company or one of its delegates which could be detrimental to the investors of a fund, it can decide, after proper notification to the management/investment company, to increase the number of controls or arrange for deeper reviews of certain processes that have or might have caused financial impacts. The depositary may be required to notify the CSSF of any event or weakness notified or escalated by the depositary to the management/investment company, if the management/investment company has failed to take adequate measures or does not provide the depositary with a satisfactory and timely response to the material issue raised.

Without undue delay, the management/investment company has to inform the depositary of any issue or event which can have a detrimental impact on the fund or its investors.

Any confirmed irregularity has to be escalated to the management/investment company, and if it remains unresolved after an acceptable delay, to the fund's auditors and/or the authorities.

The periodicity of the reviews performed by the depositary as well as the escalation process should be documented in an operation memorandum agreed between the depositary and the management/investment company.

The depositary also needs to ensure that management/investment companies have their own defined escalation procedures which include a requirement to notify depositaries where discrepancies or potential problems arise. Such escalation procedures may also be part of the depositary operating memorandum or service level agreement.

GLOSSARY

- AIFMD** Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.
- AIFMD-CDR** Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.
- CSSF Circular 02/77** CSSF Circular of 27 November 2002 on the protection of investors in case of NAV calculation error and correction of the consequences resulting from non-compliance with the investment rules applicable to undertakings for collective investment.
- CSSF Circular 16/644** CSSF Circular of 11 October 2016 on the provisions applicable to credit institutions acting as UCITS depositary subject to Part I of the law of 17 December 2010 relating to undertakings for collective investment and to all UCITS, where appropriate, represented by their management company. This circular replaces the circular 14/587 on the same topic.
- ESMA/2011/379** ESMA's technical advice to the European Commission on possible implementing measures of the AIFMD ("Final Report").
- Funds** Throughout the document the terms "funds" or "fund" include both UCITS and AIF, unless otherwise explicitly mentioned.
- Law of 2010** Law of 17 December 2010 concerning undertakings for collective investment.
- UCITS Directive** Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 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 of the European Parliament and of the Council of 23 July 2014 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions.
- UCITS-CDR** Commission Delegated Regulation (EU) No 2016/438 of 17 December 2015 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries.

Acronyms

- AIF** Alternative Investment Fund within the meaning of the AIFMD
- CSSF** Commission de Surveillance du Secteur Financier
- ESMA** European Securities and Markets Authority
- UCITS** Undertakings for Collective Investment in Transferable Securities
- SIAG** Self-managed SICAV

ANNEX I

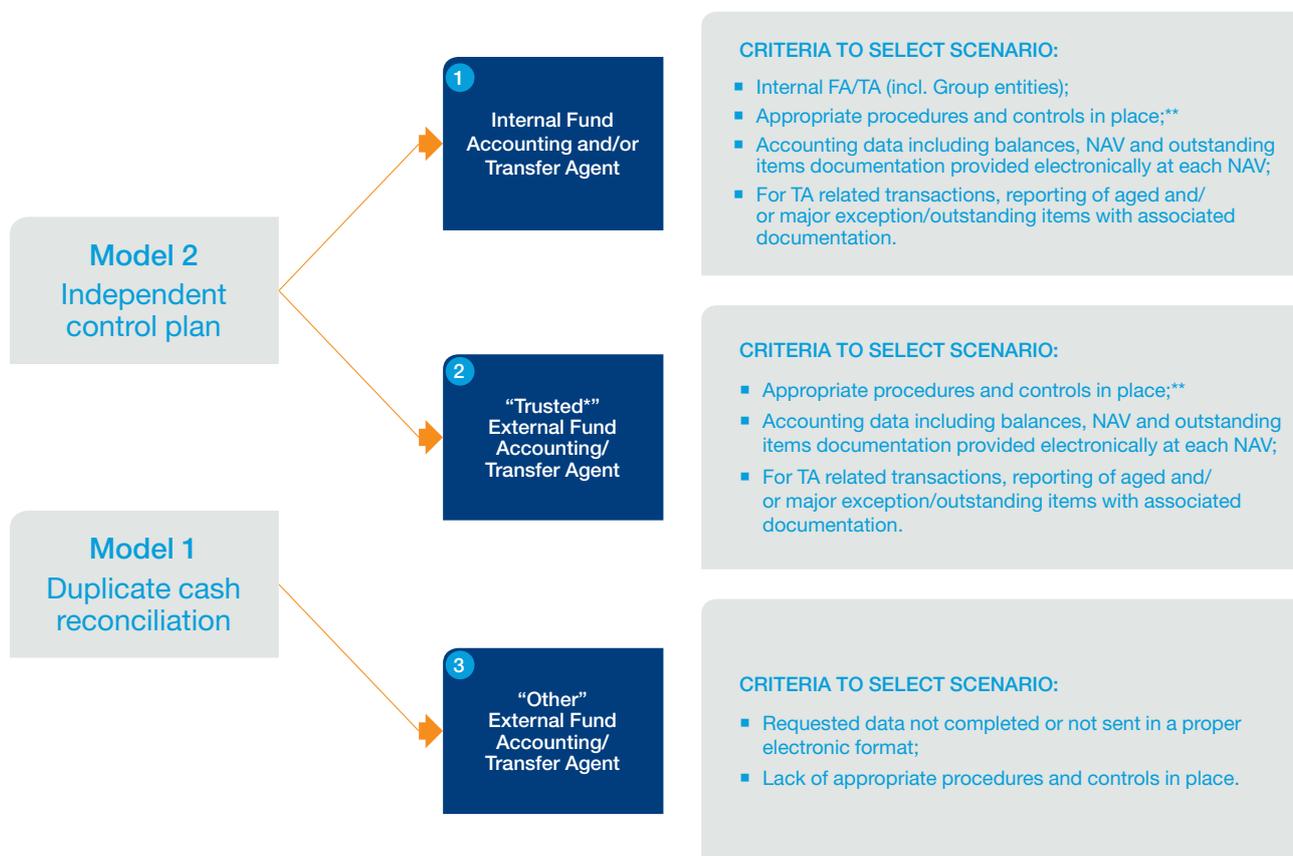
CASH FLOW RECONCILIATION

2 options to meet the regulatory obligation of cash flows reconciliation (without shadow NAV):

- Model 1 – Duplicate cash reconciliation
- Model 2 – Independent control plan

Model

Scenario



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NB: FA will be primarily used for the portfolio trading & corporate life (including payment of invoices) of the Fund, whereas TA reconciliation will only be relevant for subscriptions and redemptions if the collection accounts are at the name of the fund (or at the name of the Depository/the ManCo/AIFM on behalf of the fund).

* "Trusted" external service providers (FA, TA) are providers that meet sufficient expertise, reporting and responsiveness criteria.

** The depository has verified that external service provider has appropriate procedures and controls in place. This could be done for instance by means of receiving an ISAE 3402 report or equivalent reports.

Model 1 Duplicate cash reconciliation

1) DATA COLLECTION

CASH RECORDS

INTERNAL A/C
Fund cash movements and balances from Custody

EXTERNAL A/C & BROKERS A/C
Fund cash transactions and balances (MT940)

COLLECTION ACCOUNTS FALLING UNDER CASH MONITORING (IF ANY)
Cash movements from internal or external collection account

FA AND TA RECORDS

INTERNAL OR EXTERNAL FA
Fund accounting general ledger

INTERNAL OR EXTERNAL TA
Subscriptions and redemptions orders

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2) DUPLICATE RECONCILIATION

CONFIRMED EXCEPTIONS

Owner: Depository Team

1. Control frequency: on NAV date +1;
 - a. Independent matching of cash balances
 - b. Independent matching of cash movements
 - c. If balances and movements do not match continue to d., otherwise stop
 - d. In-depth analysis of unmatched items
2. Contact FA/TA and/or Custody to clarify;
3. Store evidence of control & upload control results as follow-up file.

3) ESCALATION

E-MAIL

Owner: Depository Team

1. Review unmatched items;
2. 2nd level Escalation: Fund manager, auditor, regulator (model can vary depending of location).

Client Auditor Regulator

Model 2 Independent control plan

1) DATA COLLECTION

CASH RECORDS

INTERNAL A/C
Fund cash movements and balances from Custody

EXTERNAL A/C & BROKERS A/C
Fund cash transactions and balances (MT940)

COLLECTION ACCOUNTS FALLING UNDER CASH MONITORING (IF ANY)
Cash movements from internal or external collection account

FA AND TA RECORDS

INTERNAL OR EXTERNAL FA
FA cash balances & cash reconciliation matched and unmatched items from FA

INTERNAL OR EXTERNAL TA
Major and/or lasting exceptions from TA reconciliations

2) INDEPENDENT CONTROL

CONFIRMED EXCEPTIONS

Owner:
Depository Team

Control on FA reconciliations

1. At least monthly, depending on the risk profile of the fund (growing list of outstanding expected if not in daily NAV)
 - a. Control if custody balances match with FA, if not continue to b, otherwise stop
 - b. Verify that FA balance + unmatched = Custody balance, if not investigate for missing elements. In both cases continue to c
 - c. Control unmatched items exceeding investigation thresholds defined:
 - In absolute and/or relative terms (fund materiality may be taken into account in this regard); and over a certain age and link with significant cash flow ("SCF") results.
 - In terms of ageing.
 Then link the review with the SCF results;
2. Contact FA and custody to identify possible reasons for exceptions (1st level escalation);
3. Store evidence of control;
4. Forward control results to depository teams.

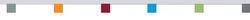
3) ESCALATION

E-MAIL

Owner:
Depository Team

1. Control results to validate unmatched items validation
1. 2nd level escalation : 2nd) Fund manager, 3rd) auditor, 4th) regulator (model can vary depending of location)

Client Auditor Regulator





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