

## Regulatory News Alert

### ESMA opinion on asset segregation

2 August 2017

#### Context

On 20 July 2017, [the European Securities and Markets Authority \(ESMA\)](#) issued an opinion to the intention of the Commission to update the current legislations on UCITS, AIFMD, and CSDR regarding both:

- The asset segregation requirements in case of delegation of safe-keeping duties by the appointed depositary of a fund (UCITS or AIF); and
- The application of depositary delegation rules to CSDs.

Asset segregation is a topic that arose in the context of the preparation of AIFMD. The regulator's idea was to identify assets belonging to a particular fund among all assets held in the depositary chain, in order to protect those assets in case of insolvency. The issue gained further attraction with the work on UCITS V, focusing on depositaries and largely copying the requirements of AIFMD.

When talking about segregation, two opposite visions coexist:

- The one that considers that full segregation whatever the cost, whatever the complexities, is the only option
- The industry opinion by large, which is to stick with the dispositions of bankruptcy law

This opinion is the first official communication on that matter and even though it is not final, nor binding, its importance should not be underestimated.

#### Key takeaways

##### A. Asset segregation

Let us not keep the suspense running for too long: **ESMA largely agreed in its opinion to the current market realities: segregation to protect assets does not necessarily imply full account segregation at the fund/individual level.** ESMA recognizes that what is important is that assets are protected in case of failure of a financial intermediary.

- ESMA proposes to use the model: **own account, client account, fund accounts (UCITS/AIF)**
- ESMA replicates the model at sub and following levels: **own account, client of level above depositary, level above depositary own assets**

That approach **allows ESMA to reconcile two opposite regulatory requirements, segregation of account and recognition of the omnibus structures.** *(See more on that below)*

## B. Application of depositaries delegation rules to CSD

Although the topic was raised in the consultation, ESMA delivers a key point of view on the interactions between depositaries and CSDs. **ESMA differentiates the role of CSDs between their issuer agent status and their intermediary/investor status.**

- ESMA considers that when a CSD is acting as the issuer agent (issuer CSD), not only does it not fall into the segregation requirements at all, but it might act as a “shield” to protect the depositary above it in the custody chain. Hence, the assets are considered protected in the UCITS/AIFMD context.
- In the case where the CSD is acting as investor, ESMA considers that it is acting as a “regular” custodian; hence, it should abide by similar rules to the AIFMD/UCITS.

*(See more on that below)*

## Detailed analysis

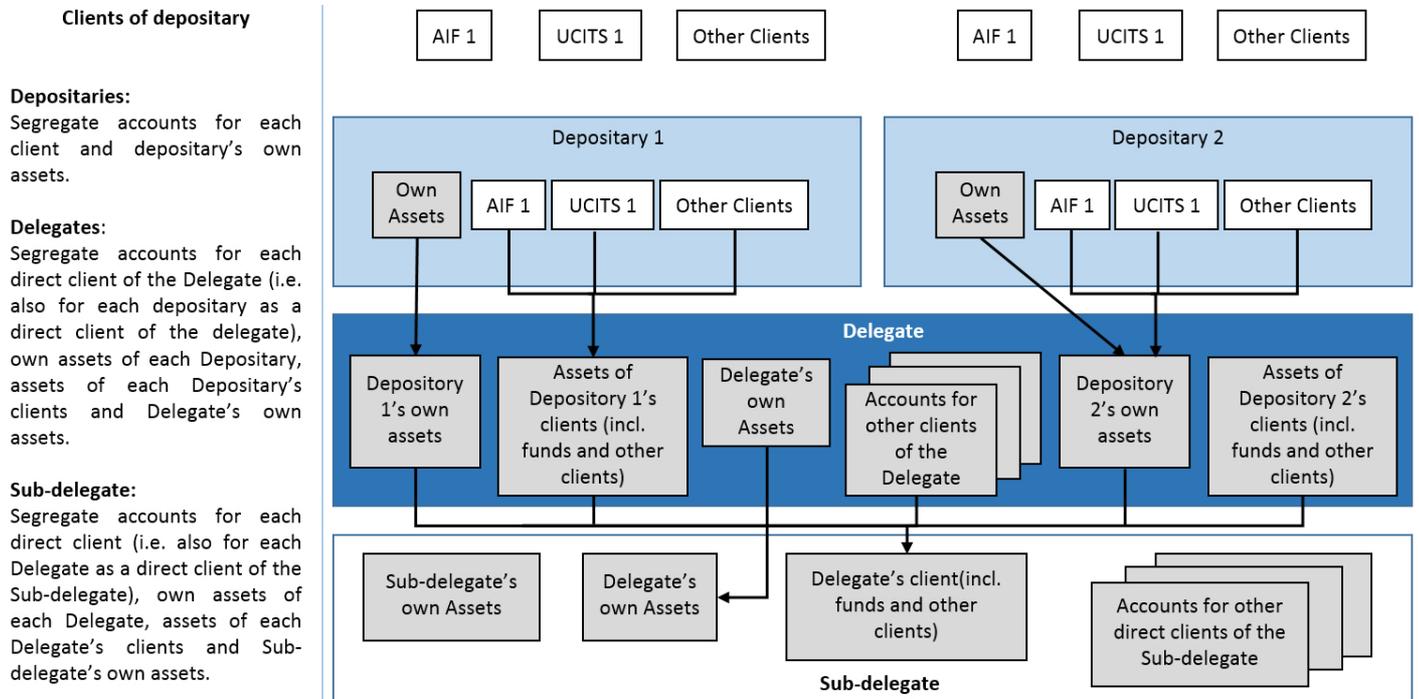
From an industry standpoint, **the ESMA approach largely validates the diversity of existing models. This position stresses the prime importance of timely and accurate reconciliation and bookkeeping** (know where your assets are and volume) rather than to a specific model of account organization. Furthermore, the vast majority of legal systems across the EU and the globe considers that assets are held by depositaries for the account of a client, hence separated from their own assets. These assets are therefore placed under a bankruptcy remote situation. This also helps solve many issues raised in the context of prime brokerage. **This approach from ESMA largely lets each model live as they are today, as long as they meet certain requirements that are now common market practices.**

ESMA presents several diagrams of how asset holding should be organized from level 0 (fund and its direct depository) to the levels below sub-depositaries, sub-sub... depositaries.

The principle relies on the following separation:

- Own account assets
- Funds' assets and clients' assets at depository (level 0)
- A commingling of assets at sub-depository level: own assets of the sub-depository, assets of the depository and clients assets of the level 0 depository whatever they are

The most notable impact of this proposal is that ESMA requires that this setup be replicated for each level from the level 0 depositaries. This means that for each depositary, the sub-depositary has to create a client account and an own account for the depositary own assets. At subsequent sub-custodian levels, the process is the same (own account, client accounts, and level above depositary account).



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## Key changes

A. Regarding minimum asset segregation requirements at the level of the delegate for UCITS or AIF

ESMA invites the EU institutions to consider legislative clarifications in the UCITS and AIFMD framework in order to prescribe the following minimum requirements at the level of the delegate:

- a minimum of 3 different segregated accounts per depositary should be required at the level of the delegate as follows:
  1. own assets of the delegate,
  2. own assets of depositary, and
  3. assets of depositary's clients

- The use of omnibus accounts (i.e. those comprising assets of different clients of depositaries, but excluding own assets of the delegate or of the depositary) should be subject to the following conditions:
    1. ensuring that assets are not available for distribution to creditors of the failed entity;
    2. accurate accounting and reconciliation systems allowing the depositary to verify that - for each of its UCITS and/or AIF clients – the number and type of financial instruments registered in the accounts opened in its books matches with the number and type of financial instruments belonging to its UCITS and/or AIF clients which are recorded on the financial instruments accounts of the delegate (where instruments belonging to other clients may also be kept);
    3. reconciliation measures under (2) being conducted as often as necessary depending not only on the dealing frequency of the relevant UCITS or AIF, but also on any trade which would occur even outside the dealing frequency (e.g. a UCITS or AIF with weekly dealing frequency which trades on a daily basis would require daily reconciliations). Moreover, reconciliation measures would also need to be conducted depending on any other transaction happening in relation to any of the other client assets kept in the omnibus account;
    4. processes ensuring that reuse of securities is only allowed if provided for in the relevant contracts and permitted by the relevant legislation;
    5. written contract being concluded between the depositary and the delegate; and
    6. the contract between the depositary and the delegate providing for:
      - a. the depositary's right of sufficient information, inspection, admittance and access, to enable the depositary to have oversight of the whole custody chain in order to ensure that its arrangements satisfy the policy objective and to enable the depositary to fulfil its oversight and due diligence obligations; and
      - b. respective rights to be agreed on between the delegate and the sub-delegate in the event of a sub-delegation.
- (ESMA34-45-277; §89)

## B. Regarding depositary delegation rules to CSDs

ESMA invites the EU institutions to consider legislative clarifications in the UCITS and AIFMD framework in order to prescribe the following regime for the application of depositary delegation rules to CSDs:

1. Depositaries should not be required to apply the delegation rules under the AIFMD/UCITS Directive to CSDs, in their capacity as Issuer CSDs. As consequence and for the avoidance of doubt:

a. There would be no specific segregation requirements at the level of the issuer CSD;

b. Due diligence: A depositary would not have to perform any due diligence under Article 21(11) AIFMD or under Article 22a of the UCITS Directive on an Issuer CSD; and

c. Liability: In the case of a loss of a financial instrument at the level of the Issuer CSD, this loss is to be regarded as an external event beyond the reasonable control of the depositary, since the loss is attributable to the Issuer CSD. Any liability by the CSD will be subject to the relevant law to which the CSD is subject.

2. Depositaries should be required to apply the delegation rules under the AIFMD/UCITS Directive to CSDs, in their capacity as Investor CSDs. This means the following:

a. Segregation requirements at the Investor CSD: Investor CSDs would be subject to the revised asset segregation requirements in line with the suggestions made under Section 3.1 of the present opinion (see also Annex IV) which are compatible with Article 38 CSDR;

b. Due diligence: In appointing the Investor CSD as a delegate, the depositary should comply with the due diligence requirements under the AIFMD and UCITS Directive. However, while appointing an Investor CSD authorised or recognised under CSDR, a depositary should do the following:

- rely on the CSD authorisation or recognition while assessing the ex-ante due diligence requirements under Article 21(11)(a) to (c) of AIFMD (as implemented by Article 98(2) of the AIFMR) and Article 22a(2) of UCITS Directive (as implemented by Article 15(3) of the UCITS V Regulation), and
- assess the ongoing due diligence requirements under Article 21(11)(d) of AIFMD (as implemented by Article 98(3) of the AIFMR) and Article 22a(3) of UCITS Directive (as implemented by Article 15(3) of the UCITS V Regulation); and

c. Liability: A depositary delegating to an Investor CSD would remain subject to the standard liability regime, in line with the provisions under Article 21(12) and (13) AIFMD and Article 24(1) to (4) UCITS Directive. For the avoidance of doubt, this implies the following:

- in the case of a loss of a financial instrument at the level of the Investor CSD, the standard strict liability regime as per the AIFMD/UCITS Directive would apply to a depositary, i.e. the depositary remains liable unless it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary; and
- a transfer of liability from the depositary to the Investor CSD would only be allowed under the strict conditions set out under Article 21(13) AIFMD, while no transfer of liability would be allowed for UCITS, as per the provisions of Article 24(2) and (3) UCITS Directive.

(ESMA34-45-277; §140)

## Next steps

This opinion is part of a larger review process led by the EU Commission to address and review the trade and post-trade landscape in the context of the CMU (Capital Market Union) launched last year with the EPTF (European Post Trade Forum) group of experts.

The debate on the segregation of assets has entered a new area, with ESMA finally succeeding in giving a point of view.

Down the road, the texts of UCITS, AIFMD, and CSDR should be amended, with all the accompanying regulatory processes. This means that if a solution arises out of this ESMA opinion, the road until full recognition and enforceable legal changes is still a long and winding road, with potential surprises.

## How can we help?

Deloitte actively monitors UCITS, AIFMD, and CSDR developments and subsequent publications on an ongoing basis. We carefully analyze all relevant published documents in order to identify any changes and to provide the most updated view to our clients.

Our team of experts is available to answer any questions you may have on this key topic for your market place and we will be pleased to facilitate a workshop to discuss the latest regulatory updates as well as potential operational impacts and remediation scenarios for your business.

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