

Regulatory News Alert

Important update UCITS/AIF depositary rules

31 May 2018

The European Commission (EC) publishes drafts amending Delegated Regulation (EU) No 2016/438 and Delegated Regulation (EU) No 231/2013 with regard to safe-keeping duties of depositaries

Following the opinion of the European Securities and Markets Authority (ESMA) on asset segregation, the EC has published on 28 May 2018 **two draft proposals**, which aim to amend Delegated Regulation (EU) No 2016/438 and Delegated Regulation (EU) No 231/2013 **relating to the safe-keeping duties of depositaries of UCITS and AIFs**.

It is recalled that ESMA identified issues where the understanding among stakeholders differs and invited the EC to clarify certain obligations of depositaries in case they delegate safe-keeping functions to third parties. ESMA proposes that the asset segregation requirements be better defined and complemented by additional safeguards, in particular the requirement to contractually ensure a sufficient flow of information between the depositary and the custodian or sub-custodian. It also suggests strengthening the requirement to maintain accurate record keeping and reconciliation systems, including calibrating the frequency of reconciliations with respect to the frequency of trading activities relating to all the assets that might be kept in an omnibus account.

The EC acknowledged that securities and insolvency laws are currently not harmonized on a European level and that it is imperative to have common rules to ensure protection of assets safe-kept by depositaries or custodians for their clients. This should lead to the clear identification of assets belonging to a particular UCITS or AIF and to the protection of such assets in the case of insolvency of the depositary or the custodian. The dedicated provisions of Directive 2011/61/EU and Delegated Regulation (EU) No 231/2013 pursue these objectives. Nevertheless, diverging applications by national competent authorities and market participants of the obligations for depositaries with regard to safe-keeping of UCITS and AIF clients' assets risk undermining the objectives pursued by the existing regulations, which is why the EC wants to clarify these rules in order to facilitate their uniform interpretation.

The Commission considers that:

1. Sufficient experience has been gained to conclude that the **obligations for depositaries need to be clarified further,**
2. **ESMA's opinion reflects a thorough technical assessment of the rules on safe-keeping function,**
3. There is an **urgent need to provide more clarity on the rules on asset segregation** to ensure their uniform application throughout the EU

Key proposed amendments

The proposal covers the following amendments to Delegated Regulation (EU) No 2016/438:

- Article 13(1)(c) is amended to provide for the factors that should **determine the frequency of reconciliation between the depositary's financial securities accounts and internal records and those of the third parties** to which safe-keeping functions have been delegated. The trading frequency of the depositary's UCITS client and the trades carried out by other clients, whose assets are held in the same omnibus account, must be taken into account.
- Article 13(2) is amended to require that the depositary maintains a record in its financial instruments account opened in the name of a UCITS client or in the name of the management company acting on behalf of the UCITS, showing that the assets kept in custody by a third party belong to a particular UCITS client. The **depositary must at all times have a complete overview of the assets of its UCITS** clients where the custody of assets has been delegated to a third party.
- Article 15 is accompanied by paragraph 2a to prescribe the **minimum details that should feature in the contract between a depositary and a third party on delegation of custody of assets** of the depositary's UCITS clients. The depositary must be able to identify all the entities in the custody chain and **secure access to all the relevant information in the third party's possession** to be able to verify the quantity of the identified financial instruments kept in custody by the third party. Should the third party need to delegate the custody function to another third party, the proposed provision requires the delegating third party to contractually secure equivalent rights from that other third party, as itself granted to the depositary.

- Article 16 is amended to clarify the asset segregation requirements for the third parties (custodians) to which the custody of UCITS assets has been entrusted. **A custodian can hold assets of UCITS and AIF clients and other clients of one depositary in the same omnibus account, provided its own assets, proprietary assets of the depositary and assets belonging to other clients of the third party are held in segregated financial instruments accounts.** To ensure increased asset protection and facilitate the depositary's duty of oversight of the entrusted assets, **custodians must issue depositaries with a statement whenever a change relating to the safe-kept assets occurs.** New technological solutions might be particularly helpful in facilitating this process. Factors to determine the frequency of reconciliation mirror those set out in the amendment to Article 13(1)(c) of the Delegated Regulation.
- Points (d) and (e) of Article 17(2) and paragraph (3) of Article 17 are deleted because it is proposed to incorporate them into Article 16(1) of the Delegated Regulation pertaining to the record-keeping obligations and transmission to the depositaries of relevant information affecting the status of safe-kept UCITS assets. This is relevant for the depositaries' monitoring of assets safe-kept by any third party to whom this function has been entrusted, regardless of whether the third party is located inside or outside the EU.

The draft proposal covers the following amendments to Delegated Regulation (EU) No 231/2013 on AIFMD depositaries:

- Article 89(1)(c) is amended to provide for **the factors that should determine the frequency of reconciliation between the depositary's financial securities accounts and internal records and those of the third parties to which safe-keeping functions have been delegated.** The trading frequency of the depositary's AIF client and also the trades carried out by other clients, whose assets are held in the same omnibus account, must be taken into account.
- Article 89(2) is amended to require that the **depositary maintains a record in its financial instruments account opened in the name of an AIF client or in the name of the AIFM acting on behalf of the AIF** showing that the assets kept in custody by a third party belong to a particular AIF client. The depositary must at all times have a complete overview of the assets of its AIF clients where the custody of assets has been delegated to a third party.
- Article 98 is accompanied by paragraph 2a to prescribe the **minimum details that should feature in the contract between a depositary and a third party on delegation of custody of assets of the depositary's AIF clients.** The depositary must be able to identify all the entities in the custody chain and secure access to all the relevant information in the third party's possession to be able to verify the quantity of the identified financial instruments kept in custody by the third party. Should the third party need to delegate the custody function to another third party, the **proposed provision requires the delegating third party to contractually secure equivalent rights** from that another third party, as itself granted to the depositary.

- Article 99 is amended to **clarify the asset segregation requirements for the third parties (custodians) to which the custody of AIFs assets has been entrusted**. A custodian can hold assets of UCITS and AIFs clients and other clients of one depositary in the same omnibus account, provided its own assets, proprietary assets of the depositary and assets belonging to other clients of the third party are held in segregated financial instruments accounts. To ensure increased asset protection and facilitate the depositary's duty of the oversight of the entrusted assets, custodians must issue depositories with a statement whenever a change relating to the safe-kept assets occurs. New technological solutions might be particularly helpful in facilitating this process. Factors to determine the frequency of reconciliation mirrors those set out in the amendment to Article 89(1)(c) of the Delegated Regulation.
- Article 99 is also amended to introduce new obligations for depositaries that delegate the custody of assets to third parties located outside the EU. **Legal advice from independent parties on the insolvency laws of the third country is required**. The depositaries should also ensure that the third party complies with their national laws securing the benefits of asset segregation and that the third party communicates any changes to the insolvency laws which are a part of the legal system in which they are operating.

Both proposals are currently open for consultation until 26 June 2018.

How can Deloitte help?

Deloitte can help depositaries to understand and comply with the regulatory constraints applicable to them through different services. We can also help you stay on top of regulatory trends with our Kaleidoscope Regulatory Watch service.

1. Governance Definition and Implementation

We work with you to design and calibrate your policies and procedures to fulfill your legal duties with practical implementation throughout your organization.

2. Regulatory healthcheck

We can review your compliance with each requirement of the regulation, identifying any gaps with remediation actions for depositaries as for their counterparties.

3. Due Diligence support

Our teams of experts test the compliance of your business partners and ensure an external review of the adequacy of internal frameworks with the applicable laws and regulations.

4. ISAE 3402/SOC 1 examination

We conduct independent reviews on the adequacy and operating effectiveness of the depositary's internal control procedures and provide "reasonable assurance" on the depositary's control environment, including advice on best practices and improvement opportunities.

5. Remedial planning and implementation

We assist the depositary in organizing and planning the implementation of new requirements and provide guidance on key operational set-up decisions, control framework upgrades, or service offering reviews.

Your contacts

Simon Ramos

Partner – Advisory & Consulting IM
Leader
Tel : +352 45145 2702
siramos@deloitte.lu

Lou Kiesch

Partner – Regulatory Consulting Leader
Tel : +352 45145 2456
lkiesch@deloitte.lu

Gerard Lorent

Director – Strategy & Corporate
Finance
Tel : +352 45145 4278
gelorent@deloitte.lu

Benoit Sauvage

Senior Manager – RegWatch, Strategy
and Consulting
Tel : +352 45145 4220
bsauvage@deloitte.lu

Deloitte Luxembourg
560, rue de Neudorf
L-2220 Luxembourg

Tel: +352 451 451
Fax: +352 451 452 401
www.deloitte.lu

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