

Regulatory News Alert

New EU Commission Delegated Draft - Safe keeping for UCITS funds

27 July 2018

On 12 July, The EU Commission released its delegated regulation on safe-keeping duties for UCITS depositaries. This document, released in parallel with a similar proposal for AIF funds, proposes new interpretations for some of the key tasks performed by UCITS depositaries in relation to segregation, reconciliation and the relationship with the custody network.

The delegated act will become official once agreed by the EU Parliament and EU Council in three months from its publication if all goes according to plan.

Themes covered in the delegated act:

- 1. Reconciliation:** between the depositary's own records and the third-party to whom the safe-keeping might have been delegated to should be conducted as frequently as required, which means according to the UCITS trading activity, or when trades by other clients held on the same security account occur.

That interpretation aims to ensure that reconciliation is performed more frequently and should give an official cycle for reconciliation, when it was until now left to more subjective criteria.

- 2. Sub-custody contracts:** the delegated act identifies the provisions that the sub-custody contract should contain among which are:
 - a. A **guarantee of access to information and inspection** across all intermediaries
 - b. Identification of all entities in the custody chain
 - c. Verification of **holding records at each intermediary up to the issuer Central Security Depository (CSD)**

- 3. Sub-custody organization:** the depositary shall ensure that the sub-custodian it uses is able to correctly **identify the records of all financial instruments on the financial instrument accounts**. The depositary should ensure that its sub-custodian is able to exclude proprietary assets of the depositary, the own sub-custodian assets, and other clients from the sub-custodian so as to be able to identify instruments held in the name of UCITS (clients or the management company acting on behalf of the fund, as the delegated acts mentions). The records should allow the depositary to **identify with accuracy and without delay the relevant assets**.

Two interpretations can be derived from this third element: the approach is slightly different from the current interpretation, the accent is now put on "records" instead of "accounts" and the "ability to locate" instead of "access", and this proposal should reflect current industry practices.

Then, on top of this, and probably more importantly for the industry, a second interpretation arises from the new wording: the text now distinguishes between segregation to prevent bankruptcy risk, from segregation to allow identification and access. Hence, the use of the word "records"— accuracy instead of segregated accounts — reflects that approach. That should mean that the account segregation objective pursued by the EU Commission to limit bankruptcy has been discarded to the profit of accurate information. Taken a step further, that might mean as well that there would be a reconciliation of approaches between Prime Brokerage and custody. Now, provided that UCITS assets are bankruptcy remote in the jurisdiction, the recourse to omnibus structures that identify records would satisfy regulatory obligations.

Besides these core elements, the text details governance that should be applied across the custody chain in order for the depositary to be able to identify and locate the different financial instruments it holds for its UCITS clients, notably through ensuring a right to information.

The delegated act also amends the requirement about the **insolvency regime of a country** to also focus on the confirmation that as in the EU client's assets are held in their name and for their account and could not form part of the potentially failing sub-custodian assets accessible by creditors.

And in the end the Manco has to demonstrate to the competent authority of the UCITS' home that its choice of depositary is made in the sole interest of UCITS' investors.

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Your contacts

Simon Ramos

Partner – IM Advisory & Consulting Leader

Tel: +352 45145 2702

siramos@deloitte.lu

Pascal Martino

Partner – Banking Leader

Tel : +352 45145 2119

pamartino@deloitte.lu

Laurent Collet

Partner - Strategy Regulatory
& Corporate Finance

Tel: +352 45145 2112

lacollet@deloitte.lu

Jean-Fançois Giuliani

Senior Manager - Strategy Regulatory
& Corporate Finance

Tel: +352 45145 2403

jgiuliani@deloitte.lu

Benoit Sauvage

Senior Manager – RegWatch, Strategy &
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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