CSSF Circular 14/587 on UCITS Depositaries

In a nutshell

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The CSSF recently published a Circular inviting Luxembourg UCITS and their depositaries to anticipate the so-called directive 'UCITS V' via a substantial alignment and harmonization with the common elements of the UCITS and AIFMD depositary regimes.

The Circular provides that its recipients must comply with its provisions by 31 December 2015 at the latest, i.e. less than three months ahead of UCITS V which is to be im-plemented by 18 March 2016.

A closer scrutiny at the rules contained in the Circular further shows that what might appears to be an unusual 'gold-plating' move by Luxembourg should in fact prove to be for many operators a confirmation of their current best-market practice.

For both practical and cost-effective reasons, UCITS depositaries might consider implementing the terms of the Circular and of UCITS V at the same time, and thus be (almost) fully UCITS V compliant on depositary aspects by 1 January 2016.

The Circular draws particular attention to certain aspects deemed essential in relation to the depositary function

A. The Circular in general

1. **Circular 14/587**—On 11 July 2014, the Luxembourg Commission for the Supervision of the Financial Sector (CSSF) published a new circular numbered 14/587 and entitled *"Provisions applicable to credit institutions acting as UCITS depositary subject to Part I of the law of the 17 December 2010 relating to undertakings for collective investment and to all UCITS, where appropriate, represented by their management company"* (the 'Circular' and the 'UCI Law', respectively).[1]

2. **Recipients**—The Circular targets and applies (A) to Luxembourg credit institutions, including the Luxembourg branches of EEA credit institutions, acting as depositaries of Luxembourg UCITS within

1 *The full text of the Circular in French is accessible on the CSSF website and an English translation will soon be published on the EHP website*

the meaning of articles 17 and 33 of the UCI Law, as well as (B) to these Luxembourg UCITS themselves, including, as the case may be, UCITS management companies[2]. Other Luxembourg funds and SICARs (including their management companies or managers, as the case may be) and their depositaries remain governed either by the regime instituted by the Alternative Investment Fund Managers Directive (AIFMD) or that resulting from the basic Luxembourg legal provisions applicable to depositaries, as implemented by Chapter E of IML Circular 91/75.

3. **Purpose and content**—The purpose of the Circular is to clarify the depositary regime provided for by the UCI Law by defining new organisational arrangements that must be put in place by the Circular's recipients in terms of the UCITS depositary function's duties, obligations and rights. The Circular draws particular attention to certain aspects deemed essential in relation to the depositary function. Among these elements, the Circular sets out rules relating, inter alia, to the segregation of UCITS assets throughout the delegation chain, the initial and ongoing due diligence of the entities intervening in the custody chain of the UCITS assets, the identification, resolution and avoidance of conflicts of interest, and the adequate booking and monitoring of cash flows. The Circular also describes organisational rules and rules of conduct with which credit institutions should comply in order to be approved as UCITS depositaries. A number of the rules set out in the Circular are discussed in further detail in Chapter 2 of this memorandum.

4. **AIFMD and UCITS V, alignment and anticipation**—*"The Circular establishes, as far as practicable[3], an alignment and anticipates a harmonisation of the UCITS and AIF's depositary regimes with respect to their common elements, as implemented by the so-called directive 'UCITS V'"*[4,5]. This is true. The Circular, however, falls short of implementing some of the fundamental changes of UCITS V[6], the first of which being the strict liability regime for loss of assets held in custody[7], and that—to a large extent[8] and as already stated under paragraph 3 of this memorandum—the Circular only clarifies via more detailed and prescriptive guidelines most of the key rules contained and drafted in a principled-based format in IML Circular 91/75 when defining the missions of the depositary. As a matter of fact, the Circular[9] remains in line with the key principle of the parliamentary works (confirmed by IML Circular 91/75) whereby the mission of the depositary is a mission of surveillance and not of custody. However, this does not prevent the Circular from distinguishing certain organisational arrangements to be implemented depending on whether assets are held in custody or not.

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2 In this memorandum, reference to 'UCITS' must be understood, where applicable, as including a reference to this UCITS' management company

3 The CSSF might have more rightly provided "as far as the current UCITS legal framework allows it"

4 See the third paragraph of the Circular's introduction

5 'UCITS V' designates the UCITS Directive 2009/65/EC as last amended by Directive 2014/91/EU of 23 July 2014. This latter Directive was published in the OJEU of 28 August 2014, i.e. post date of publication of the Circular

6 Precisely because the current UCITS legal framework does not allow it

7 As a matter of fact, the Circular expressly provides that "Regarding the liability regime applica-ble to UCITS depositaries, because this aspect is not covered by the Circular, one should refer to the legal provisions applicable under the UCI Law"*; to which we should probably add* "as imple-mented by point IV, of Chapter E of the IML Circular 91/75" *(even though the latter is expressly repealed by the Circul ar as from 1 January 2016 in relation to UCITS depositaries)*

8 The Circular also covers points (such as the cash monitoring obligations) that were not specifically addressed in Chapter E of the IML Circular 91/75

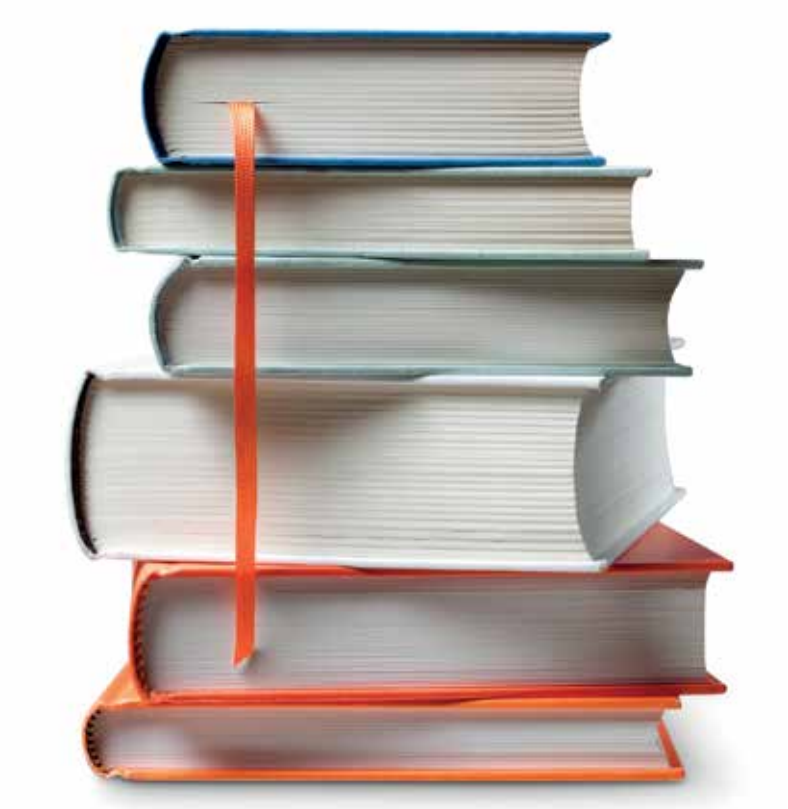
9 See Point 46 of the Circular

5. **Timing**—The Circular provides that its recipients must comply with its provisions by 31 December 2015 at the latest, subject to other transitional provisions that might become applicable once UCITS V is implemented. This means quite a long (and welcome) transitory period of almost 18 months. It is interesting to note that, without prejudice to its own transitory regime, the UCITS V framework will come into force on 18 March 2016.

B. Certain elements of the Circular in particular

6. **Approbation**—Luxembourg law does not provide for a specific 'depositary licence'. It does, however, require the depositary to be approved in relation to any appointment by a UCITS[10]. The Circular[11] now conveniently provides detailed rules regarding the file to be submitted, the procedures to be implemented and the conditions to be fulfilled for a depositary to be granted such approval. In this context, due consideration must be given to the characteristics of each relevant UCITS, meaning that the same depositary may be approved in relation to certain types of UCITS, but not in relation to other types of UCITS. A non-exhaustive list of the information to be submitted to the CSSF (and to be kept up-to-date) is provided in Appendix 2 of the Circular. The Circular contains favourable transitory provisions for existing UCITS depositaries[12].

7. **Depositary agreement**[13]—The CSSF has always requested that the involvement of a depositary for a given UCITS be drawn up in a written agreement. The Circular confirms this requirement, but now lists the elements that this agreement must cover and defines certain key principles governing it. These elements and principles[14] are contained in Chapter 3 of Part II and in Appendix 1 of the Circular. Appendix 1 of the Circular is closely inspired by article 83.1 of AIFM Regulation 231/2013.



8. **Depositary/UCITS relationship**—Regarding the relationship between the depositary and its UCITS clients, and in addition to the foregoing requirements applicable to the depositary agreement, the Circular[15] requires that each of its recipients establishes and implements an appropriate **escalation procedure** for situations where an anomaly is detected, including possible notification of the CSSF, and lists certain rules and conditions with which these procedures must comply. The Circular[16] also provides for a (reciprocal) **obligation of information** between the depositary and its UCITS clients.

10 Article 129(2) of the UCI Act

11 Chapter 2 of Part II of the Circular

12 Point 7 of the Circular

13 The Circular refers to the "depositary designation agreement"

14 These elements and principles come in addition to those referred to in Chapter V of CSSF Regula-tion N° 10-04 in relation to a UCITS whose management company is not based in Luxembourg

15 See Chapter 4 of Part II and Points 186 of the Circular

16 See Parts IX and X of the Circular

9. **Conflicts of interest**—The Circular dedicates a specific chapter[17] to the rules and procedures with which the depositary must comply in relation to conflicts of interest. In this context, the Circular specifies, inter alia, that:
    - No delegation of the core investment management function can be made to the depositary or to an entity involved in the custody chain
    - The delegation of the core investment management function, however, is not restricted to an entity linked to the depositary by common management or control
    - Although the risk management function cannot be delegated to the depositary, the latter can be entrusted with certain duties linked to the aforementioned risk management function
    - Subject to certain conditions specified in the Circular, the depositary may act vis-à-vis its UCITS client in different capacities (administration and transfer agent, e.g.), which are non-exhaustively listed in Point 32 of the Circular
    - Subject to certain conditions relating inter alia to conflicts of interest, the depositary may hold equity interest in its UCITS client's management company
    - No one employed by the depositary may act as conducting officer of a UCITS
10. **Governance of the depositary functions**—The Circular[18] requests that the depositary establishes and implements written procedures and, where appropriate, enters into specific appropriate contractual arrangements with third parties in relation to its functions as depositary.

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17 Chapter 1 of Part III of the Circular
18 Chapter 2 of Part III of the Circular

These procedures and contractual arrangements cover, inter alia, the types of mandates (based on the characteristics of the UCITS) the depositary considers itself able to service, the depositary's internal process for accepting new designations by a specific UCITS, the relationships with third parties (such as administrative agents) with whom the depositary must liaise when performing its functions, and more generally, all aspects linked to the function of the depositary. The Circular also specifically requires the intervention of the depositary's internal audit and control department to ensure that all such procedures and contractual arrangements are drawn up, updated and implemented.

11. **Organisational requirements**—Almost half of the Circular, namely Part IV entitled *"Organisational arrangements to be implemented in relation to the UCITS assets"* and Part V entitled *"Booking and adequate monitoring of cash (flows)"*, is dedicated to the depositary's organisational requirements. A detailed examination of these requirements clearly exceeds the scope of this memorandum. In the following bullet points, we propose instead to express a few general comments to highlight a few points we deem of particular interest.

    - The common denominator of these organisational requirements is that, in one way or another and either directly or indirectly, they concur that the depositary should at all times fulfil its main mission of having an overall view of how the UCITS' assets are invested and where they are located, whilst having sufficient comfort of the UCITS' ownership rights over these assets.
    - The majority of these organisational requirements are closely inspired by the requirements detailed in articles 21.7 and 21.8 of the AIFMD, and in their implementing articles 85 to 91 of AIFM Regulation 213/2013.
    - The Circular makes a distinction between the requirements applicable to the assets held in custody by the depositary[19], the assets held in custody by third party custodians/sub-custodians and by any party further down the custody chain[20] and to the assets not held in custody[21]. An additional distinction is made between the cash and non-cash assets, the former being subject to the specific booking and monitoring requirements provided for in Part V.
    - The Circular requires the **segregation** of the UCITS' assets both at internal[22] and at third-party levels[23,24]. For the most part, the Circular aligns itself with the segregation rules and principles contained in articles 21.8 and 21.11 of the AIFMD and in articles 89, 98 and 99 of the AIFM Regulation 213/2013. In the context of the segregation at third-party level, the Circular refers to the somewhat new concept of *"assets [of the depositary's clients] being subject to collective management"*[25]. We understand a depositary would then be required to open and maintain a minimum of three accounts with its correspondents: (i) one for these assets subject to collective management (presumably the assets belonging to all the depositary's clients qualifying as UCIs or SICARs, whether AIFs, UCITS or not), (ii) one for the assets of its other clients and (iii) one for its own assets.

19 Chapter 1 of Part IV of the Circular

20 Chapters 2 and 3 of Part IV of the Circular

21 Chapter 4 of Part IV of the Circular

22 See point 55 of the Circular

23 See points 57-60 and 63 of the Circular

24 The Circular also addresses or reiterates its segregation requirements in the context of the due dili-gence process to be implemented by the depositary (points 74-75 of the Circular), of the designa-tion of a prime broker (point 99 of the Circular), of the concentration of custody with a limited number of third parties, or even with a single third party (point 104 of the Circular), of cash ac-counts (point 118 of the Circular) and of the minimum content of the depositary agreement (An-nex 1 (o) of the Circular)

25 Point 74.e) of the Circular refers to a 'more granular' segregation at third party level as it refers to 'assets of the depositary's UCITS clients'. This is a clerical error in the drafting of the Circular

- Without prejudice to the foregoing, the Circular requires that initial and on-going **due diligence** be conducted in relation to any entity involved in the custody chain of, or the intermediation with, the UCITS assets, and, if need be, that back-up plans be made operational and relevant measures be taken when any of these entities fails to comply with its obligations. The Circular provides quite detailed and prescriptive (non-exhaustive) rules and principles in this regard, some of which are also largely inspired by the AIFMD provisions. These rules and principles distinguish between the due diligence to be performed in relation to assets held in custody[26] or not[27]. The Circular reserves specific developments for the due diligence to be performed in relation to the investments made by the UCITS in other UCIs[28].

The Circular confirms the principle whereby any such oversight or control can be performed ex post

- The Circular reiterates, in a more detailed and prescriptive format[29], the obligation contained in IML Circular 91/75 whereby the depositary must ensure a direct **right of information and instruction** in relation to the UCITS' assets, including in the context of collateral arrangements. Vis-à-vis entities intervening in the 'second degree' of the custody chain, this right of information and instruction may be indirect[30].
- The Circular contains specific, sometimes quite detailed and prescriptive, organisational requirements in relation to:
  - **Collateral** arrangements[31]
  - Investments made by the UCITS (i) in **derivative** financial instruments[32] or (ii) in **other UCIs**[33]
  - The designation of a **prime broker**[34]
  - **Concentration of custody** with a limited number of third parties, or even with a single third party[35]
- The Circular[36] provides for a general obligation to establish, update and implement **reconciliation** procedures covering all the assets of the UCITS and related transactions, and clarifying the measures to be taken by the depositary in case a discrepancy is identified.
- In relation to **cash assets,** the Circular[37] aligns itself with the cash monitoring obligations set forth in article 21.7 of the AIMFD and its implementing articles 85 to 87 of AIFM Regulation 213/2013. It hence anticipates UCITS V which, in that respect, mirrors[38] the aforementioned AIFMD provisions. In this context, the depositary is required to ensure that UCITS cash accounts are opened only with entities meeting the requirements of article 21.7 of the AIFMD (a 'qualified entity').

26 Sub-chapter 5.1 of Part IV of the Circular
27 Sub-chapter 5.2 of Part IV of the Circular
28 Sub-chapter 5.3 of Part IV of the Circular
29 Chapter 6 of Part IV of the Circular
30 See point 86 of the Circular
31 Sub-chapter 7.1 of Part IV of the Circular
32 Sub-chapter 7.2 of Part IV of the Circular
33 Sub-chapter 7.5 of Part IV of the Circular
34 Sub-chapter 7.3 of Part IV of the Circular
35 Sub-chapter 7.4 of Part IV of the Circular. To be read in conjunction with Chapter 6 of Part VI of the Circular
36 Chapter 8 of Part IV of the Circular
37 Chapter 1 and 2 of Part V of the Circular
38 It is to be noted, however, that if UCITS V (see new article 22.4) indirectly authorises cash accounts to be opened with a bank authorised in a third country, it does not seem to authorise (as the AIFMD does) cash accounts to be opened with "another en-tity of the same nature, in the relevant market where cash accounts are required provided that such entity is subject to effective prudential regulation and supervision which have the same effect as Union law and are effectively enforced"

Chapter 3 of Part V of the Circular deals with the obligations of the UCITS and the depositary in relation to money resulting from subscriptions (and, as a matter of fact, redemptions). In this context, point 127 of the Circular specifically provides that 'collection accounts' (which may in substance be defined as the accounts through which transit monies are exchanged between the UCITS and the investors) must also be opened with qualified entities.

12. **Specific duties of the depositary**—Chapter VI of the Circular is dedicated to the specific duties of the depositary and is split into two chapters:

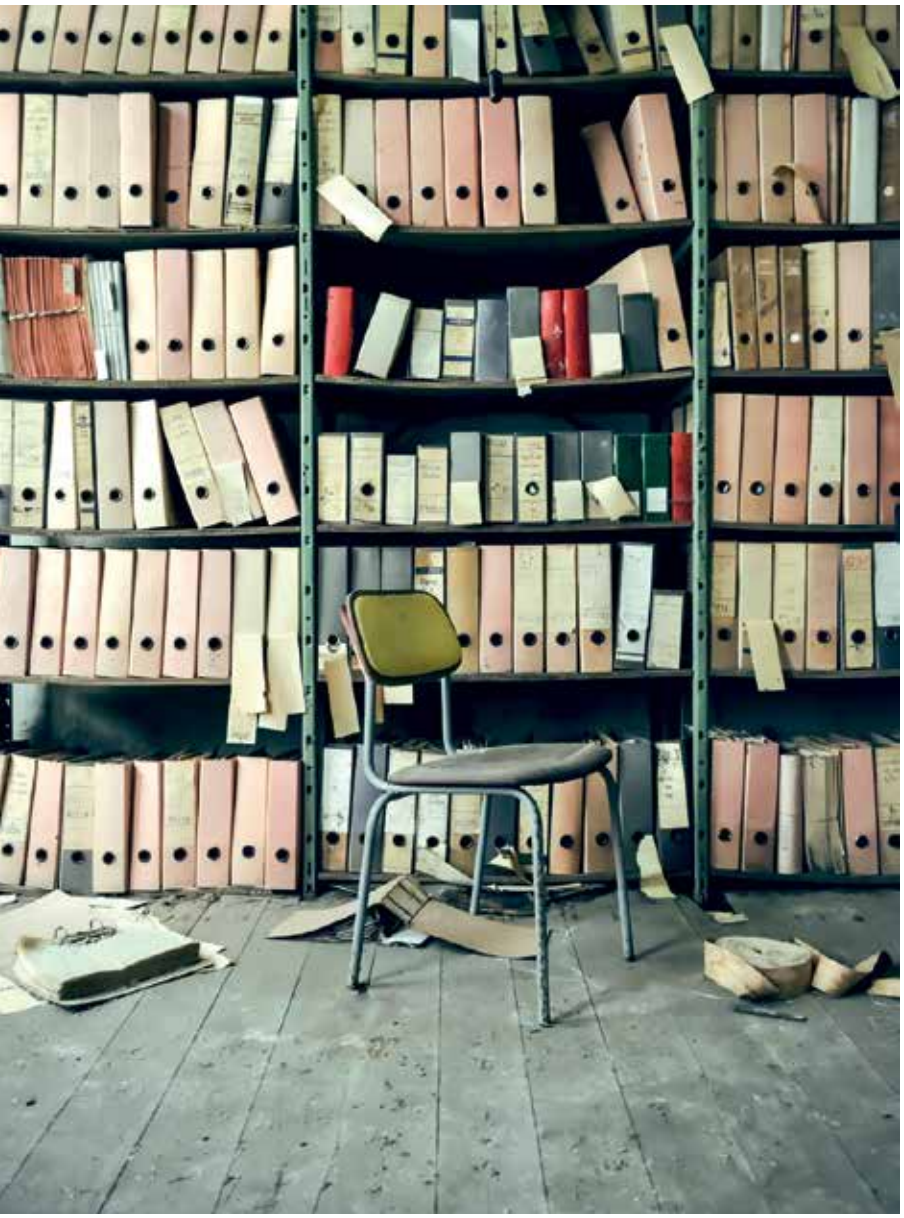
    - Chapter 1 deals with the depositary's obligations regarding the day-to-day administration of UCITS assets. It does not deviate substantially from what was already set out in IML Circular 91/75 in this regard. The Circular does, however, recommend that these obligations be extended to corporate UCITS.
    - Chapter 2 deals with the specific oversight duties of the depositary and, for the most part, aligns itself with article 21.9 of the AIFMD and its implementing articles 92 to 97 of AIFM Regulation 213/2013. In this context, the Circular confirms the principle whereby any such oversight or control can be performed ex post. As in Chapter 1, the Circular recommends that the specific oversight duties actually implemented in relation to corporate UCITS be aligned with all those imposed in relation to contractual UCITS.

13. **Delegation**—It has always been agreed that, subject to a few conditions and limitations, the depositary can delegate part of its duties and mission to third parties. The merit of Part VII of the Circular[39] is to reiterate this principle and to provide a more comprehensive set of rules applicable to such delegation. In part VII, the Circular:

    - Provides the general rules[40] and limitations[41] applicable to any delegation by the depositary
    - Addresses the specific rules applicable to delegation within the depositary group[42], to the IT outsourcing[43] and the concentration of custody with a limited number of third parties, or even with a single third party[44]
    - Confirms the possibility for sub-delegation under the condition that delegation rules are applied by analogy to the parties concerned[45]

C. What to do next and when?

14. **Introduction**—The Circular undoubtedly requires action to be taken. These actions are first and foremost to be taken by depositaries. It would not be well-advised to unduly minimise the workload required for the Circular's recipients to comply with the new framework. However, in our opinion and as indicated in paragraph 4 above, it remains that the Circular does not introduce rules that are so fundamental as to imply significant changes and hinder implementation. It is also likely that the majority of depositaries are already compliant with most of the required changes. First of all,this is because most UCITS depositaries are also depositaries of AIFs managed by authorised AIFMs and therefore comply with the AIFMD requirements (including in relation to their network of correspondents). Secondly, this is because a number of rules contained in the Circular reflect current Luxembourg best-market practice. In the following paragraphs, we nevertheless suggest a (non-exhaustive) list of actions to consider, as well as to anticipate the implementation of the UCITS V regime.



15. Some suggested action to be taken—Recipients of the Circular are recommended to take advantage of the coming (more than one-year) period to perform the following action (non-exhaustive list):

(a) Screening by the depositary of its internal governance and organisation and, where required, filling in any identified shortfalls, particularly regarding:

- The conditions for approval as a UCITS depositary and updating the CSSF (as of 1 January 2016) in relation to the various elements and information listed in Appendix 2 of the Circular
- The capacity to handle new mandates and the process for accepting such new mandates
- The required functional and hierarchical separation of functions, for instance when the depositary is also responsible for performing administration functions or risk management duties for its UCITS clients

(b) Regarding its relationship with its UCITS clients, the depositary will pay particular attention to:

- The depositary agreement, as the latter shall certainly be brought in line with the requirements referred to in paragraph 7 of this memorandum
- The escalation procedures to be established and documented as per the rules briefly described in paragraph 8 of this memorandum
- Its information obligations as per Part VIII of the Circular

(c) Screening by the depositary of the network of sub-custodians and third-party custodians regarding:

- The due diligence already implemented. This due diligence should be expanded if need be

39 To be read in conjunction with certain developments contained in Parts IV and VI of the Circular
40 Chapter 1 of Part VII of the Circular
41 Chapter 4 of Part VII of the Circular
42 Chapter 2 of Part VII of the Circular
43 Chapter 3 of Part VII of the Circular
44 Chapter 6 of Part VII of the Circular
45 Chapter 5 of Part VII of the Circular

- The content of the agreements entered into with these entities
- Conflicts of interest (e.g. delegation of the investment management function)
- Segregation of assets

(d) Screening by the depositary of all of the UCITS' cash correspondents (including 'collection account' holders):

- To verify their eligibility
- To ensure that the reconciliations and flows of information necessary to implement its cash monitoring functions are duly organised and implemented

(e) In addition to what is provided for under (c) and (d) above, screening the relationships with all intervening third parties (including prime brokers, collateral agents and collateral managers, etc.) and to address any shortfalls identified in terms of the Circular's specific requirements with each of these parties including, where applicable, the delegation requirements.

(f) The UCITS will pay particular attention to the following points:

- The depositary agreement (see paragraph (b) above)
- The escalation procedures with the depositary (see paragraph (b) above)
- The depositary's information obligation as per Part VIII of the Circular
- The cash accounts opened or to be opened (see paragraph (d) above)

16. **UCITS V directly?**—The period (before being somewhat overhauled by UCITS V and its implementing detailed provisions) appears to be less than three months. In order to avoid the extra costs and time that a 'two-step upgrade' of systems, organisation, contractual documentation and procedures, etc. would entail, UCITS depositaries might consider 'skipping' the Circular phase and ensure fully UCITS V compliance by 1 January 2016, therefore in advance of UCITS V's compulsory implementation date (i.e., 18 March 2016). If depositaries were to choose this option, they could postpone, to the latest possible date (via appropriate transitory provisions inserted in the depositary agreement), the implementation of the most stringent UCITS V rules such as the strict liability regime applicable to the loss of assets held in custody. The main merit of the Circular might then well be to encourage depositaries to adopt a smooth transition to UCITS V, whilst gradually avoiding any practical issues that would only be revealed upon actual implementation of a new regime, and thus ultimately keep Luxembourg ahead of the EU pack.

To the **point**:

- The CSSF recently published a Circular inviting Luxembourg UCITS and their depositaries to anticipate the so-called directive 'UCITS V' via a substantial alignment and harmonisation with the common elements of the UCITS and AIFMD depositary regimes
- The Circular provides that its recipients must comply with its provisions by 31 December 2015 at the latest, i.e. less than three months ahead of UCITS V which is to be implemented by 18 March 2016
- A closer scrutiny at the rules contained in the Circular further shows that what might appear to be an unusual 'gold-plating' move by Luxembourg should in fact prove to be for many operators a confirmation of their current best-market practice
- For both practical and cost-effective reasons, UCITS depositaries might consider implementing the terms of the Circular and of UCITS V at the same time, and thus be (almost) fully UCITS V compliant on depositary aspects by 1 January 2016