# European Depositary Regimes – A comparison of UCITS IV, UCITS V and AIFMD

Another key piece of European asset management regulation will soon be in place as UCITS V enters into force on 17 September 2014.

UCITS V will amend the current UCITS regime to address perceived discrepancies across the European Union on the duties and liability of depositaries, remuneration policy and sanctions, which became evident in the wake of the collapse of Lehman Brothers and the Madoff scandal.

This briefing will focus on some of the key issues arising from the new depositary regime, comparing it to the current regime under UCITS IV and to the recently introduced depositary regime for alternative investment funds under the AIFMD.

## Harmonisation of Depositary Regimes

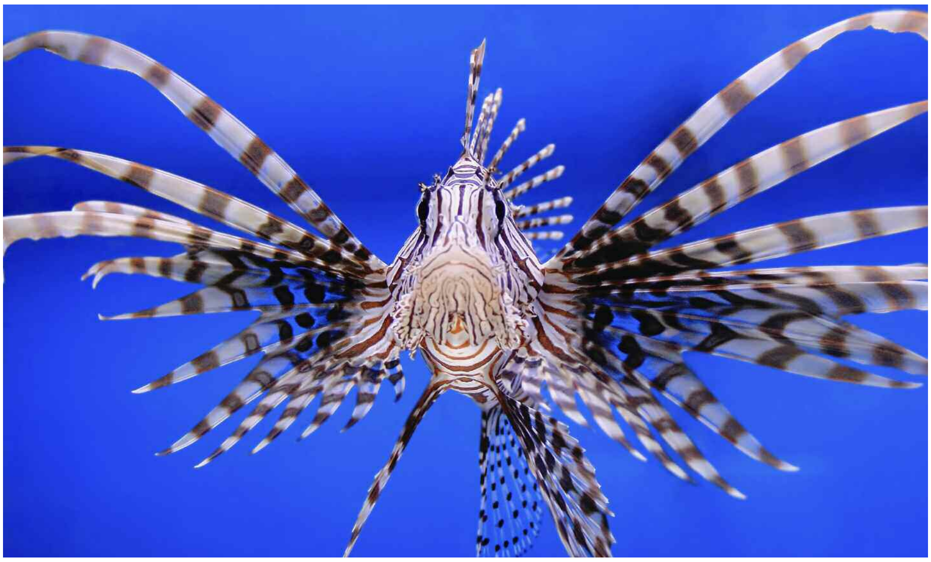
One of the key objectives of UCITS V is to harmonise depositary rules across Europe in order to increase investor protection. European countries have implemented the UCITS IV depositary rules in different ways, leading to legal uncertainty in keys areas (such as depositary liability) and varying levels of investor protection from one country to the next. UCITS V, therefore, sets out additional rules, including on the tasks and duties of depositaries, designating the legal entities that may be appointed as depositaries and clarifying the liability of depositaries in the event that the assets of the UCITS are lost in custody or in the case of depositaries' improper performance of their oversight duties. The rules are the same, irrespective of the legal form of the UCITS, and UCITS V no longer distinguishes between UCITS with a corporate form (investment companies) and UCITS in a contractual form.

Recognising the need for harmonisation across the investment management sector as a whole, and not just in the UCITS space, the depositary regime for UCITS is aligned as much as practicable with that for alternative investment funds under AIFMD.

The end result is the introduction of new or amended rules for UCITS depositaries, which to some extent mirror those of AIFMD, and which raise several important issues for depositaries.

**UCITS IV and V: Key Differences**

- Appointment of a single depositary
- Contractual requirements
- Oversight
- Cash monitoring
- Safekeeping of assets
- Use of assets
- Insolvency of a depositary
- Delegation
- Eligibility criteria
- Operational Issues
- Liability
- Conflicts of interest
- Provision of information to competent authorities



## UCITS V depositary regime in summary

| | |
|---|---|
| Scope | Applies to UCITS established in EU member states |
| Entry in force | 17 September 2014<br>Member states have 18 months to transpose UCITS V into national law<br>New rules to apply by 18 March 2016<br>Investment companies or management companies must appoint a depositary that complies with the UCITS V eligibility requirements by March 2018, if their existing depositary does not meet the eligibility requirements in March 2016. |
| What's next? | Delegated Acts including:<br>■ Conditions for fulfilling the independence requirement referred to in conflict of interest provisions<br>■ Particulars to be included in the written contract with the depositary<br>■ Conditions for performing the depositary functions<br>■ Due diligence duties of depositaries<br>■ Segregation obligation<br>■ Steps to be taken by the third party delegates<br>■ Conditions and circumstances in which financial instruments held in custody are to be considered to be lost<br>■ What is to be understood by external events 'beyond reasonable control' for liability purposes |
| | No dates are available as yet for the Level 2 or Level 3 measures |

"…The new depository obligations are likely to apply from transposition. …This is similar to the AIFMD approach…"

## Key Issues

### Appointment of a single depositary

Like AIFMD, UCITS V requires the appointment of a single depositary for each fund, to have general oversight over UCITS assets and to provide fund managers and investors with a single point of reference in the event of problems in relation to the safekeeping of assets or the performance of oversight functions.

Currently, there is no requirement for a single depositary to hold the assets of the UCITS, so we shall see a transition from multiple to single depositary structures and increased competition in the industry – where there are currently multiple depositaries for a UCITS, each depositary will be keen to ensure that they are appointed as the single depositary.

### Depositary eligibility criteria

UCITS V introduces stricter eligibility criteria for depositaries, in the areas of prudential regulation, capital requirements and effective supervision.

Under the new regime, eligible UCITS depositaries will comprise national central banks, EU authorised credit institutions and, providing certain minimum requirements are met, "another legal entity" authorised under the laws of member states to perform depositary activities for UCITS.

Existing UCITS depositaries that fail to meet the new criteria can continue to act as depositaries for UCITS that have already appointed them for a further period of 42 months from the date on which UCITS V comes into force.

The UCITS V criteria are different and more restrictive than AIFMD. Some requirements might be problematic e.g. the minimum requirement for the depositary to have the infrastructure necessary to keep in custody financial instruments that can be registered in a financial instruments account opened in the depositary's books.

### Liability

UCITS V introduces a more rigorous liability regime than is currently in place. Under UCITS IV, a depositary is liable for any loss resulting from its 'unjustifiable failure' to perform its obligations or its 'improper performance' of them. European countries have interpreted this in different ways, which has lead to varying degrees of investor protection. To maximise investor protection and to ensure alignment across the EU, UCITS V has taken a modified strict liability stance, which largely mirrors AIFMD – the depositary is liable to the UCITS and the unit-holders of the UCITS for the loss by the depositary or its delegate for assets held in custody unless it can prove that the loss has arisen as a result of external events outside its reasonable control, the consequences of which would have been unavoidable despite all reasonable effort to the contrary. As regards 'other assets', the depositary continues to be liable in cases of negligence or intentional failure to properly fulfil its obligations.

Interestingly, UCITS V makes clear that the liability of the depositary is not affected by delegation (see below) and that the liability of the depositary cannot be excluded or limited by agreement.

### Impact of UCITS V – key areas

- Aligning with AIFMD documentation and compliance procedures
- Amending UCITS template documents to align with UCITS V
- Updating marketing procedures and internal educational materials
- 'Re-papering' and negotiating with clients

### Written Contract

Under the existing regime, where a management company's home member state is not the UCITS' home member state the depositary must sign a written agreement with the management company. UCITS V retains the need for a 'written contract' and also imposes some additional requirements (e.g. that the contract must show that the depositary has been appointed). This mirrors the approach in AIFMD. Like AIFMD, detailed content requirements for the written contract will be set out in the Level 2 text.

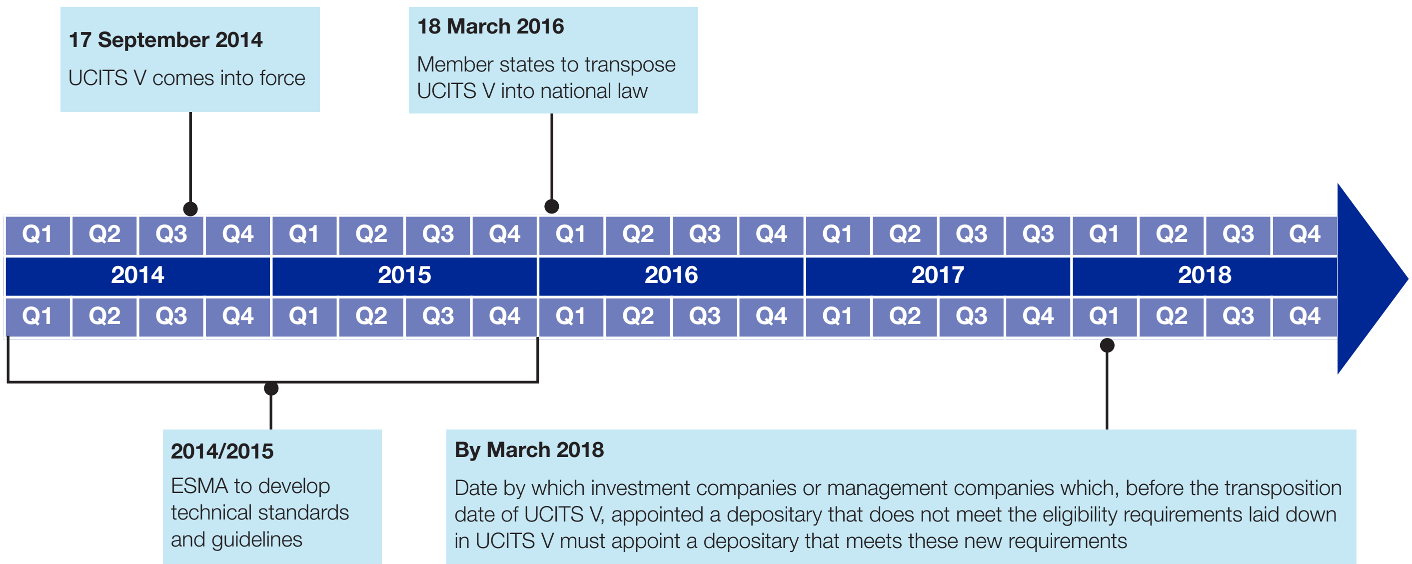
The new approach is likely to have significant documentation implications as depositary agreements will need to be amended to cover the new depositary functions. This will almost certainly involve a degree of 're-papering' existing clients.

### Cash Monitoring

There is a new regime for cash monitoring which mirrors that in AIFMD at Level 1. The depositary is responsible for the proper monitoring of the cash flows of the UCITS, and, in particular, for ensuring that investor money and cash belonging to the UCITS is

> "…The UCITS V depository requirements in many ways mirror AIFMD… It should be noted, however, that UCITS V goes beyond AIFMD in some important respects…"

## UCITS V estimated timings




booked correctly on accounts opened in the name of the UCITS, or in the name of the management company acting on behalf of the UCITS or in the name of a depositary acting on behalf of the UCITS and in accordance with MiFID principles. Where cash accounts are opened in the name of the depositary acting on behalf of the UCITS, the cash must be kept separate from the depositary's own cash.

Detailed provisions on cash monitoring will be required and these will be set out in the Level 2 text.

Implementing the cash monitoring requirements will no doubt have operational implications for depositaries, although significant 'build-costs' may be avoided by those already operating under the AIFMD, given that the requirements are expected to be similar.

### Safekeeping

UCITS V significantly expands the safekeeping requirements of UCITS IV, setting out more detailed requirements in an attempt to ensure greater harmonisation across the EU. The requirements appear similar to those in AIFMD, although further detail is to be provided in the Level 2 text, including those relating to segregation.

UCITS V clarifies that the safekeeping requirements apply not just to assets capable of being held in custody (e.g. securities) but also to other assets (e.g. derivative contracts) that cannot be held in custody and to which record-keeping and ownership verification requirements apply instead. Any asset held in custody for a UCITS must be distinguished from the depositary's own assets and be identifiable at all times as belonging to the UCITS.

The safekeeping requirements are probably the most cumbersome element of UCITS V and will require careful consideration.

### Use of Assets

UCITS V introduces new requirements on the use of UCITS assets held in custody, which are more stringent than those in the AIFMD. Under the new regime, assets held in custody by the depositary cannot be re-used by the depositary, or by a third party to which the custody function has been delegated, for their own account. Re-use of assets for the account of the UCITS is permitted, subject to certain conditions e.g. where the re-use is for the benefit of the UCITS and in the interest of the unit-holders and where the transaction is covered by high-quality and liquid collateral received by the UCITS under a title transfer arrangement. These requirements may have implications for securities financing transactions, although the precise impact on UCITS funds may vary from country to country.

### Delegation

UCITS V introduces new requirements on delegation, distinguishing oversight and cash management functions from safekeeping functions. Only delegation of safekeeping functions is permitted, subject to certain conditions being met e.g. the depositary having exercised all due skill, care and diligence in the selection, appointment, periodic review and ongoing monitoring of any sub-custodian.

The delegation requirements are broadly similar to AIFMD, but there are some important differences relating to liability (see above) and the requirement that the UCITS prospectus contain information on the depositary, including for example, a description of any safekeeping functions delegated by the depositary, the list of delegates and sub-delegates and any conflicts of interest that may arise from such a delegation. In addition to inclusion in the prospectus, up-to-date information must be made available to investors on request.

The delegation requirements are likely to prove challenging from an operational perspective. It is also interesting that UCITS V makes it clear that the depositary must take all 'necessary steps' to ensure that in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are not part of the insolvent's estate.

### Oversight Function

As stated above, one of key features of UCITS V is that it regulates the depositary regime of all UCITS (i.e. investment companies and management companies of mutual funds). This will have an impact in several ways, including in relation to the regulation of the oversight function. For management companies, the requirements will be familiar, as the UCITS V requirements are broadly similar to those of UCITS IV. However, what is new under UCITS V is that the provisions now refer to investment companies, since former article 32 of UCITS IV (now deleted) did not include these obligations for depositaries of investment companies.

## Conclusion

As can be seen from the above discussion, the UCITS V depositary regime raises a number of significant issues. Coming in the wake of AIFMD, firms will once again be required to assemble a team with business, risk, legal and compliance representation to scope out the implementation exercise. This is likely to be another time consuming and costly exercise.

## European Depositary Regimes
## A comparison of requirements under UCITS IV, UCITS V and AIFMD

| UCITS V Requirement | Comparison of UCITS IV and V | Comparison of UCITS V and AIFMD |
|---|---|---|
| Appointment of a single depositary | New to UCITS V<br>A single depositary must be appointed for each UCITS | Similar requirement to UCITS V |
| Depositary eligibility criteria | Significantly more detailed requirements than UCITS IV | Less detailed requirements than UCITS V |
| Liability | Significantly more detailed requirements than UCITS IV | Similar to UCITS V, except it is possible to contractually transfer liability to a delegate in certain circumstances |
| Written contract with depositary required | More detailed requirements than UCITS IV | Similar requirement to UCITS V |
| Oversight functions | Broadly similar to UCITS IV<br>Additional requirement for oversight function to be carried out in accordance with applicable national law and the fund rules or the instruments of incorporation. This now applies to investment companies and management companies | Similar requirement to UCITS V |
| Cash monitoring functions | New to UCITS V<br>Depositary must monitor cash flows and ensure cash booked to the correct cash account | Similar requirement to UCITS V |
| Safekeeping functions | Significantly more detailed requirements than UCITS IV<br>Assets to be entrusted to the depositary for safekeeping. Different requirements for financial instruments capable of being held in custody and 'other assets' | Similar requirement to UCITS V<br>UCITS V has additional requirement to provide regular inventories of UCITS assets held |
| Use of UCITS assets | New to UCITS V<br>Re-use of UCITS assets by the depositary or its delegate prohibited. Re-use of UCITS assets for the benefit of the UCITS is permitted subject to conditions | Less stringent requirements than UCITS V<br>Re-use is permitted with prior consent |
| Insolvency of a depositary | New to UCITS V<br>Member states to ensure that UCITS assets held in custody are not available to general creditors on the insolvency of the depositary or its delegate if they are located in the EU | No similar requirement in AIFMD |
| Delegation | New to UCITS V<br>Delegation of oversight and cash monitoring prohibited. Delegation of safekeeping functions permitted under certain conditions | Similar requirement to UCITS V<br>UCITS V has additional requirement that depositary takes 'all reasonable steps' to ensure that UCITS assets are not available to general creditors of the delegate upon insolvency |
| Sub-delegation | New to UCITS V<br>Permitted under the same conditions as delegation | Similar requirement to UCITS V |
| Central Securities Depositaries | New to UCITS V<br>The provision of settlement services by a CSD is not delegation of custody. Entrusting custody to a CSD or third country CSD is delegation | Similar requirement to UCITS V in respect of settlement services |
| Location of the depositary | Same as UCITS IV<br>A depositary must have its registered office or be established in the home state of the UCITS | Similar requirement to UCITS V for EU AIFs |
| Dual functions and avoiding conflicts of interest | More detailed requirements than UCITS IV<br>No management company or investment company shall also act as depositary; duty to act honestly and in interest of the UCITS and avoid conflicts of interest | Similar requirement to UCITS V |
| Replacement of the depositary | Same requirements as UCITS IV | No similar requirement under AIFMD |
| Provision of information to competent authorities | New to UCITS V | Similar requirement to UCITS V |

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