

UCITS V – Spotlight on the Depositary

UCITS V is set to be transposed into law by 18 March 2016 and clients are now beginning to plan and prepare for its impact from a depositary perspective.

Many of the depositary provisions under UCITS V are being introduced to broadly harmonise the UCITS regime with the regime introduced under AIFMD. Irish custodians will have gone through a similar process upon the introduction of AIFMD and so will be very well placed to work with their clients to transition as efficiently as possible towards compliance with UCITS V ahead of its implementation.

The UCITS V requirements regarding depositaries are as follows:

Eligibility to act as a depositary

Once UCITS V is in force, UCITS depositaries may be:

- a national central bank;
- certain credit institutions authorised in accordance with the Fourth Capital Requirements Directive (2013/36/EU) (CRD IV); or
- another legal entity authorised by a national competent authority under the UCITS Directive, which is subject to capital adequacy requirements, holding certain own funds and subject to prudential regulation, ongoing supervision and certain minimum requirements.

Depositary duties

Oversight duties and general obligations

Under UCITS V, the oversight duties imposed on depositaries include:

- verifying that units of the UCITS are sold, issued, repurchased, redeemed and cancelled in compliance with applicable laws and the UCITS rules;
- ensuring that the value of units is calculated in accordance with applicable laws and the UCITS rules;
- carrying out the UCITS manager's instructions unless they conflict with applicable laws or the UCITS rules; and
- verifying that considerations are remitted within the usual time limits and that UCITS income is applied in accordance with applicable laws and UCITS rules.

The depositary must act honestly, fairly, professionally, independently and in the interest of the UCITS and its investors.

Cash monitoring

UCITS V mirrors AIFMD regarding cash monitoring and the depositary must ensure that all subscription payments have been received and all cash is booked correctly in cash accounts that are opened in either:

- the name of the UCITS, (ii) the name of the management company acting in the name of the UCITS; or
- the name of the depositary acting on behalf of the UCITS. In order to ensure segregation of assets, where the cash account is opened in the name of the depositary acting on behalf of the UCITS none of the depositary's own cash may be deposited in that account.

Safekeeping

UCITS V distinguishes between financial instruments that may be held in custody (meaning assets capable of registration/physical delivery) and "other assets" which are subject to record keeping and ownership verification duties.

For financial instruments that may be held in custody, the depositary must:

- hold certain financial instruments in custody in an account opened in the depositary's books; and
- ensure that certain financial instruments can be registered in an account opened in the depositary's books within segregated accounts opened in the name of the UCITS or the management company acting on behalf of the UCITS, so that they can be clearly identified as belonging to the UCITS in accordance with the applicable law at all times.

For "other assets", the depositary must verify the ownership by the UCITS, or by the management company, of the assets by assessing whether the UCITS or the management company holds the ownership based on information or documents provided by the UCITS or by the management company and, where available, on external evidence. They must maintain a record of those assets and keep that record up to date. The depositary must provide a comprehensive inventory of all of the assets of the UCITS on a regular basis.

Re-use of assets

The assets held in custody by the depositary will only be allowed to be reused if:

- the reuse of the assets is executed for the account of the UCITS;
- the depositary is carrying out the instructions of the management company on behalf of the UCITS;
- the reuse is for the benefit of the UCITS; and
- the interest of the unit-holders and the transaction is covered by high quality and liquid collateral received by the UCITS under a title transfer arrangement.

The market value of the collateral at all times has to amount to at least the market value of the reused assets plus a premium.

Delegation of Depositary Duties

In general, the conditions and requirements for delegation to a sub-depositary are aligned with AIFMD.

The Directive sets out due diligence and on-going monitoring requirements and conditions upon which the depositary's safekeeping duties can be delegated to a sub-depositary. The depositary must be able to show that there is an objective reason for the delegation. As regards the due diligence to be carried out before a sub-depositary is appointed, the depositary must be able to show that "the depositary has exercised all due skill, care and diligence in the selection and the appointment of any third party to whom it wants to delegate parts of its tasks and keeps exercising all due skill, care and diligence in the periodic review and ongoing monitoring of any third party to whom it has delegated parts of its tasks and of the arrangements of the third party in respect of the matters delegated to it."

The Directive provides that the depositary can only delegate to a third party who at all times satisfies a number of requirements. These include:

- a requirement on the delegate to segregate the assets from its own assets;
- a requirement on the depositary and the delegate that, in the event of the insolvency of the delegate, assets held in custody on behalf of the UCITS must be unavailable for distribution to or realisation for the benefit of the delegate's creditors; and
- a requirement on the depositary that, where the delegate holds

assets in custody, the delegate is subject to effective prudential regulation, including being subject to minimum capital requirements, and is subject to external periodic audit to ensure that the assets are in its possession.

Where the local law requires that certain assets are held in custody by a local entity and there are no local entities that satisfy the delegation requirements, the depositary can delegate its functions to such local entity provided investors have been informed and the UCITS or the management company (on behalf of the UCITS) instructed the depositary to delegate to such local entity. Moreover, the provision of services by securities settlement systems is not considered a delegation of custody functions. Depositaries will need to update the agreements with sub-depositaries to ensure that all of the requirements are reflected in the agreement. The indemnity provisions in the sub-depositary agreement may need to be refined so that sub-depositaries indemnify the depositary in the event of a loss of any assets held by such sub-depositary. The reason for this is that the depositary will ultimately be liable for the loss of any assets held by a delegate.

Depositary liability

Under the existing UCITS IV framework, the standard of liability for loss of a financial instrument held in custody is that liability arises in case of “unjustifiable failure to perform obligations” or “improper performance” of its duties. These words have been interpreted differently in various member states, and this has resulted in different levels of investor protection. The Directive will have the effect of harmonising depositary liability by introducing the following provisions:

- The depositary will be liable to the UCITS and to the unit holders of the UCITS for the loss by the depositary or a third party to whom the custody of financial instruments held in custody has been delegated.
- In case of a loss of a financial instrument held in custody, the depositary must return a financial instrument of identical type or the corresponding amount to the UCITS or the management company acting on behalf of the UCITS without undue delay if it is deemed liable for the loss.
- The depositary shall not be liable if 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.
- The depositary’s liability will not be affected by the fact that it has entrusted to a third party all or some of its custody tasks and therefore the depositary will be liable for the loss of assets even where the loss occurred at the level of the sub-depositary.
- Apart from the case of the loss of a financial asset, the depositary will also be liable to the UCITS and its investors for all other losses suffered by them as a result of the depositary’s negligent or intentional failure to properly fulfil its obligations under the Directive.
- The Directive distinguishes between assets that are capable of being held in custody and those that are not. Therefore, a depositary will not be liable to return assets not capable of being held in custody, such as OTC derivatives, where the depositary has an obligation to verify ownership and keep a record of such instruments.
- Investors may invoke the liability of the depositary directly or indirectly through the management company or the investment company provided this does not lead to duplication of redress or to unequal treatment of investors.
- The depositary bears the burden of proof in demonstrating that it has duly performed its duties.

- Unlike the AIFMD regime, depositaries of UCITS will not be permitted to exclude or limit their liability under contract.

Level 2 measures

In advance of the transposition deadline, the European Commission will adopt implementing measures providing greater clarity on certain requirements of UCITS V. These are known as Level 2 measures. It is expected that the European Commission will adopt the Level 2 measures in Q3 2015.

What next

We anticipate that Irish depositaries will replicate their existing AIFMD service and operating models to a large extent to support the new UCITS V requirements and this will entail an amendment to contractual arrangements and service level agreements between the depositary and the UCITS.

UCITS prospectuses should be updated to include additional disclosures relating to safekeeping functions delegated by the depositary.

Pricing of the depositary service may change depending on the type of assets and in which markets as well as the change of liability standard.

There will be more work involved for the depositary with respect to cash flow monitoring, verification of ownership, safekeeping, due diligence and information flow and record keeping. They will need to work closely with any third parties, such as administrators, transfer agents, derivative and trading counterparties, securities lending agents and counterparties, collateral agents, sub-depositaries and third party banks to ensure that the operating model and processes and any agreements in place with those parties are sufficient.

We will be working closely with our clients in relation to the impact of these changes and the effect of the Level 2 measures when released. In the meantime, if you have any queries, please contact one of the partners listed or your usual contact at A&L Goodbody.



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