

Legal regime of the depositaries under UCITS V

On 15 April 2014, the European Parliament in a plenary session gave its final approval to the UCITS V Directive. Once it enters into force, Member States will have 18 months to transpose it into national law.

UCITS V focuses mainly on three areas: the remuneration policy of management companies, the sanctions regime and lastly, the legal regime of the depositaries, which is analysed in the present note.

The key elements of the new legal regime are the following: Each UCITS shall appoint a single depositary and this appointment shall be evidenced by written contract which will regulate the flow of information deemed necessary to allow the depositary to perform its functions for the UCITS.

In order to avoid conflicts of interest, the management companies shall not act as depositaries. Under Directive 2011/61 on Managers of Alternative Investment Funds (AIFMD), in addition to management companies of alternative investment funds (AIFs), prime brokers shall not act as depositaries either unless they comply with certain requirements.

The depositary shall act honestly, fairly, professionally, independently and in the interest of the UCITS and must have policies to avoid conflicts of interest in the performance of its functions.

Who are eligible entities to act as Depositaries?

The following entities may be eligible to act as depositaries:

- National central banks.
- UE Credit institutions authorised under CRD IV.
- Other legal entities authorised under the laws of Member States to carry on depositary activities under UCITS V, which are subject to prudential supervision and capital adequacy requirements and which comply with certain requirements (among others, adequate infrastructure, administrative and accounting procedures, internal control mechanisms, effective

procedures for risk assessment and effective control and safeguard arrangements for information processing systems).

- UCITS V, unlike AIFMD, includes as eligible entities to act as depositaries national central banks, but does not include investment services firms, which can be depositaries for AIFs under the AIFMD.

Duties of the Depositaries

According to UCITS V, depositaries have three main duties:

1. **Custody of financial instruments and assets of the UCITS**
 - The depositary shall hold in custody all financial instruments that may be registered in a financial instruments account opened in the depositary's books (in which case the account will be separated so that they can be clearly identified as belonging to the UCITS at all times) and all financial instruments that can be physically delivered to the depositary. Regarding other assets the depositary shall verify the ownership of the UCITS or the management company acting on behalf of the UCITS and will maintain an up-to-date record of that ownership. For this, the depositary will base on information or documents provided by the UCITS or the management company and, where available, on external evidence. The depositary shall provide the management company, on a regular basis, with a comprehensive inventory of all of the assets of the UCITS.

- **Reuse:** UCITS V, unlike AIFMD, limits the reuse regime. The term "reuse" comprises any transaction of assets held in custody including, but not limited to, transferring, pledging, selling and lending. As a general rule, the assets held in custody by the depositary shall not be reused by the depositary or by any third party to whom the custody function has been delegated. As an exception, the assets held in custody by the depositary may be reused provided that the reuse of the assets (i) is executed for the account of the UCITS, (ii) is done carrying out the instructions of the management company on behalf of the UCITS, (iii) is for the benefit of the UCITS and the interest of the unit-holders; and (iv) the transaction is covered by high quality and liquid collateral received by the UCITS under a title transfer arrangement. In this case, 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.
- **Insolvency:** Member States shall ensure that in the event of insolvency of the depositary and/or any third party located in the EU to whom custody of UCITS assets has been delegated, the assets of a UCITS held in custody are unavailable for distribution among or realisation for the benefit of creditors of such depositary and/or such third party.

2. Ensure cash flows and correct booking

- The depositary should be responsible for the proper monitoring of the UCITS' cash flows, and, in particular, for ensuring that investor money and cash belonging to the UCITS is booked correctly on accounts opened in the name of (i) the UCITS, or (ii) the management company acting on behalf of the UCITS, or (iii) the depositary acting on behalf of the UCITS, or (iv) another entity referred to in points (a), (b) and (c) of Article 18(1) of MiFID (Central Bank, European credit institution or from a third country) which complies with the principles set out in Article 16 of MiFID. Where the cash accounts are opened in the name of the depositary acting on behalf of the UCITS, no cash of the entity and none of the own cash of the depositary shall be booked on such accounts.

3. Surveillance and Monitoring

- The depositary shall ensure that the sale, issue, repurchase, redemption and cancellation of units of

the UCITS and the calculation of the NAV are carried out in accordance with the applicable national laws and the fund rules or instruments of incorporation of the UCITS. In addition, the depositary shall carry out the instructions of the management company, unless they conflict with the applicable national laws or the fund rules or the instruments of incorporation of the UCITS. Finally, the depositary shall ensure that in transactions involving the assets, any consideration is remitted to the UCITS within the usual time limits and that the income of the UCITS is applied in accordance with the applicable national laws and the fund rules or the instruments of incorporation.

Delegation of the Depositary's Duties

- Under UCITS V, like under AIFMD, the sole function that the depositary can delegate to a third entity is the safekeeping. This delegation must meet the following requirements that are along the same lines as those set out under AIFMD:
 - a. the tasks are not delegated with the intention of avoiding the requirements of the UCITS V Directive;
 - b. there is an objective reason for the delegation;
 - c. the depositary has exercised all due skill, care and diligence in the selection and the appointment of the third party and keeps exercising all due skill, care and diligence in the periodic review and ongoing monitoring; and
 - d. the depositary shall warrant that the third entity:
 - i. has structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the UCITS or the management company acting on behalf of the UCITS which have been entrusted to it;
 - ii. for custody tasks, is subject to effective prudential regulation and supervision, including minimum capital requirements and external periodic audit to ensure that the financial instruments are in its possession;

Where the law of a third country requires that certain financial instruments be held in custody by a local entity and no local entities satisfy the above delegation requirements,

the depositary may delegate its functions to such a local entity only to the extent required by the law of the third country and only for as long as there are no local entities that satisfy the delegation requirements, and only where the investors of the relevant UCITS are duly informed that such delegation is required due to legal constraints in the law of the third country of the circumstances justifying the delegation and of the risks involved in such delegation, prior to their investment; and that the management company on behalf of the UCITS, have instructed the depositary to delegate the custody of such financial instruments to such a local entity;

- iii. segregates the assets of the clients of the depositary from its own assets and from the assets of the depositary in such a way that they can at any time be clearly identified as belonging to clients of a particular depositary;
- iv. takes 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 unavailable for distribution among or realisation for the benefit of creditors of the third party;
- v. complies with the general obligations and prohibitions set out in paragraphs 2, 5 and 7 of Article 22 (written agreement, custody of financial instruments and other assets and reuse) and in Article 25 (principles of honesty, fair, professionalism, independence, etc.).

The third party may, in turn, sub-delegate those functions, subject to the same requirements. Lastly, UCITS V clarifies that the provision of services by securities settlement systems shall not be considered a delegation of its custody functions.

Liability of the Depositary

The liability regime set out in UCITS V differs from the one foreseen in AIFMD since it imposes a stricter legal regime to managers of UCITS than the rules set out in AIFMD to managers of AIFs. Under UCITS V, depositaries can neither discharge liability for loss of financial assets, even if they prove that they delegated properly, nor transfer that liability to the third delegated entity by agreement.

Under UCITS V the depositary shall be liable to the UCITS and to the unit-holders of the UCITS for the loss of the financial instruments held in custody by the depositary or the third party, being required to 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.

Likewise, the depositary shall also be liable to the UCITS and to the investors of the UCITS, for all other losses suffered by them as a result of the depositary's negligent or intentional failure to properly fulfil its obligations pursuant to Directive UCITS V.

The liability of the depositary shall not be affected by any delegation to a third entity and shall not be excluded or limited by agreement. Any agreement that contravenes this provision shall be void.

Unit-holders in the UCITS may invoke the liability of the depositary directly or indirectly through the management company provided that this does not lead to a duplication of redress or to unequal treatment of the unit-holders of the UCITS.

The only case where the depositary shall not be liable is where 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.

Contacts

Clifford Chance Madrid

Paseo de la Castellana, 110

28046 – Madrid

Tel.: +34 91 590 75 00

Natalia López Condado

Counsel, Banking & Finance

+34 91 590 75 00

natalia.lopez@cliffordchance.com

Cristina Armada

Lawyer, Banking & Finance

+ 34 91 590 75 00

cristina.armada@cliffordchance.com

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Clifford Chance, Paseo de la Castellana 110, 28046 Madrid, Spain

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