

UCITS V: Depositaries

The UCITS V Directive (“**UCITS V**”) amends the regulatory framework for Undertakings for Collective Investment in Transferable Securities (“**UCITS**”) to address issues relating to the depositary function, manager remuneration and administrative sanctions. UCITS V was published in the Official Journal of the EU on 28 August 2014, and EU member states had until 18 March 2016 to transpose the directive into national law. Ireland was one of the first EU member states to implement UCITS V. The directive principally focuses on three main areas, namely: (i) depositaries; (ii) remuneration; and (iii) sanctions. This factsheet discusses the provisions relating to depositaries. A key component of UCITS V is the clarification and harmonisation of the rules relating to the appointment, functions and liability of depositaries of UCITS.

Depositary Eligibility

Under the previous regime, member states enjoyed discretion as to the institutions deemed eligible to act as UCITS depositaries, provided that the depositaries were institutions which were subject to prudential regulation and ongoing supervision and which could furnish sufficient financial and professional guarantees. UCITS V alters the rules in relation to eligible depositaries by providing that a UCITS depositary must be: (1) a national central bank; (2) a credit institution; or (3) a legal entity authorised by its national competent authority to carry on depositary activities under the UCITS Directive, subject to the fulfilment of certain capital, prudential and organisational requirements. For Irish depositaries, the third limb would include entities authorised by the Central Bank of Ireland (the “**Central Bank**”) under the *Irish Investment Intermediaries Act 1995*.

As is the case under the Alternative Investment Fund Managers Directive (the “**AIFMD**”), under UCITS V a single independent depositary must be appointed for each fund. The purpose of this requirement is to ensure that “*the depositary has a view over all of the assets of the UCITS and both fund managers and investors have a single point of reference in the event that problems occur in relation to the safekeeping of the assets or the performance of the oversight functions.*” No company may act as both a management company and depositary or investment company and depositary.

Depositary Contracts

The depositary’s appointment must be evidenced in writing. That contract must also regulate the flow of information deemed necessary for the depositary to perform its depositary functions.

Functions and Obligations of Depositaries

In order to ensure a harmonised approach to the performance of depositary duties in all member states, irrespective of the legal form taken by the UCITS, UCITS V establishes a uniform list of oversight duties that are incumbent on UCITS depositaries in both corporate and contractual forms. These functions overlap significantly with those carried out by depositaries under the AIFMD. They include: oversight duties; a cash monitoring role; and the safe-keeping of assets. Depositaries must also ensure that UCITS’ assets are segregated from their own assets. Under UCITS V, in performing all of its tasks, a depositary must act honestly, fairly, professionally, independently and solely in the interest of the UCITS or of the investors of the UCITS.

Oversight

Under UCITS V, the oversight duties imposed on depositaries remain substantially the same as those imposed by the previous UCITS Directive and were already captured within the pre-existing Central Bank requirements. These include: verifying that units of the UCITS are sold, issued, repurchased, redeemed and cancelled in compliance with applicable laws and the UCITS’ constitutional documents; ensuring that the value of units is calculated in accordance with applicable laws and the constitutional documents; carrying out the management company’s instructions unless they conflict with applicable laws or the constitutional documents; and verifying that any consideration is remitted within the usual time limits and that UCITS’ income is applied in accordance with applicable laws and constitutional documents.

Safekeeping

With regard to safekeeping, UCITS V distinguishes between financial instruments that are capable of being held in custody by the depositary and all other assets, which are subject to record keeping and ownership verification duties. This is an important distinction in the context of the depositary liability regime introduced as part of UCITS V, which is discussed further below.

Asset Segregation and Reuse of Assets

UCITS V requires that financial instruments held in custody are registered in segregated accounts so that they can be clearly identified as belonging to the UCITS at all times. A depositary (or its delegate) is prohibited from re-using the assets which it holds in custody for its own account. The reuse of assets for the account of the UCITS is subject to conditions, including that the reuse be for the benefit of the UCITS and in the interests of unitholders and that the transaction is covered by high quality, liquid collateral received by the UCITS under a title transfer arrangement, the market quality of which at all times amounts to at least the market value of the reused assets plus a premium.

This prohibits the type of re-hypothecation seen in AIFMD structures but facilitates UCITS that wish to engage in initiatives such as securities lending.

Cash Monitoring

The depositary must ensure that cash flows are properly monitored, that is, that all payments made by or on behalf of the investors when subscribing for units in the UCITS have been received, and that all cash of the UCITS has been booked in cash accounts that are opened in the name of the UCITS or other specified entity and maintained appropriately. The Central Bank has separately published Investor Money Regulations setting out client asset rules for the investment funds industry, certain provisions of which depositaries will also need to bear in mind in drafting depositary agreements. The Investor Money Regulations are aimed at ensuring that fund service providers have stronger systems and controls in place to protect the ownership rights of investors.

Conflicts

A depositary may only carry out activities with regard to the UCITS or the management company on behalf of the UCITS in so far as these do not create conflicts of interest between the UCITS, its investors, the management company and the depositary. If those activities may create such conflicts, the depositary may only carry them out if it has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks, and the potential conflicts of interest must also be properly identified, managed, monitored and disclosed to the investors of the UCITS.

Delegation

UCITS V aligns the requirements relating to the delegation of safekeeping duties with those set out in the AIFMD. Only the safekeeping function may be delegated, subject to specified conditions including that the tasks are not delegated with the intention of circumventing the UCITS regime, the depositary must be able to demonstrate an objective reason for the delegation, and the depositary must exercise all due skill, care and diligence in the selection, appointment, periodic review and ongoing monitoring of its delegate.

In addition, the depositary must ensure that the delegate meets a range of specific conditions. The delegate must have structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the UCITS entrusted to it. Where custody tasks are delegated, the delegate must be subject to effective prudential regulation and supervision and to external periodic audit to ensure that the financial instruments are in its possession. The delegate must segregate the assets of the depositary's clients from its own assets and from the assets of the depositary, so that they can be clearly identified as belonging to the clients of a particular depositary. The delegate must comply with the same requirements applicable to the depositary regarding the reuse of assets held in custody. There is, however, an additional condition contained in UCITS V (which is not contained in the AIFMD) applying to a third party delegate which requires that "*in the event of the insolvency of the third party, securities held by the third party for UCITS are unavailable for distribution among or realisation for the benefit of creditors of the third party.*"

Recital 21 also indicates that settlement systems and central securities depositaries ("**CSDs**") may be categorised as delegates of the depositary where the custody of securities of a UCITS is entrusted to such CSD and on that basis the depositary would be responsible for any loss of assets by the CSD. The substantive provisions of UCITS V do not repeat or clarify this recital and in practice, it is likely that a CSD would be reluctant to undergo the full due diligence, ongoing monitoring and contractual responsibilities which would usually flow from an appointment as a sub-custodian. There is no equivalent provision under AIFMD.

It should be noted that, where local law requires that certain financial instruments be held in custody by a local entity and no local entities satisfy the delegation requirements, the depositary may nonetheless appoint a local entity provided certain disclosure requirements are satisfied and the UCITS or its management company has expressly instructed the depositary to delegate to such a local entity.

Prospectus Disclosure

The disclosure obligations relating to the depositary have been amended by UCITS V to provide that the prospectus must contain:

- the identity of the depositary and a description of its duties and of conflicts of interest that may arise;
- 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 delegation; and
- a statement that up-to-date information regarding the two above points will be made available to investors on request.

Prior to the introduction of UCITS V, the Central Bank already required the prospectus to disclose the material provisions of the contract between the management company or investment company and the depositary, as well as a brief description of the duties being performed and the relevant termination provisions.

Depositary Liability

Under the formerly applicable provisions, a depositary was liable for its: (i) unjustifiable failure to perform its obligations; or (ii) improper performance of them. UCITS V provides for a new strict liability regime in the context of a loss of financial instruments held in custody. In the event of such loss by a depositary (or its delegate) an obligation is imposed on the depositary to replace the financial instrument or pay the value to the UCITS without undue delay. A depositary can only avoid this strict liability standard where it can prove, cumulatively, that the loss was 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.

In contrast to the AIFMD, it is not possible under UCITS V for a depositary to contractually discharge liability in the case of the loss of assets by its delegate, meaning that the loss must be borne by the depositary rather than by the delegate. The AIFMD provides that the depositary is strictly liable for the loss of financial instruments that can be held in custody but also that, subject to certain conditions, the depositary can discharge itself of that liability by transferring it to a delegate.

Apart from the case of the loss of a financial instrument, the depositary will also be liable to the UCITS and the investors of a UCITS if a loss is suffered as a result of the depositary's negligence or intentional failure to properly fulfil its obligations under UCITS V. All UCITS investors may invoke the liability of the depositary directly or indirectly through the management company, irrespective of the legal structure of the fund. The wording of UCITS V differs to the previously applicable provisions (and the AIFMD) which stated that the right to invoke claims depends on the legal nature of the relationship between the depositary, the management company and the investors. It remains to be seen how the courts will interpret the amended provisions.

The AIFMD versus UCITS V

UCITS V seeks to align the UCITS Directive with the provisions as set out under the AIFMD in relation to depositaries. The alignment includes harmonisation in relation to depositary appointment, oversight duties, asset safekeeping and cash flow monitoring. The most obvious similarity is the requirement that an investment company or a management company must appoint a single independent depositary for each fund which it manages.

Whilst UCITS V and the AIFMD are broadly similar in approach in relation to the requirements for the depositaries, there are a number of key differences. A summary of the main differences is set out below.

- Unlike the depositary regime under the AIFMD, there is no possibility for the UCITS depositary to contractually discharge itself from liability.
- The safekeeping duties under UCITS V and the AIFMD are largely aligned and the segregation and cash flow monitoring responsibilities are largely similar. The main area where UCITS V differs to the AIFMD is in relation to asset reuse arrangements. Both directives generally permit the reuse of assets held by the depositary, but for different reasons. Asset reuse arrangements under UCITS V can only be done for the benefit of the fund, whilst, under the AIFMD, it can be done with the consent of the fund.

- In relation to the appointment more generally of third party delegates by the depositary, UCITS V contains an additional provision which is not contained in the AIFMD providing that in the event of the insolvency of the third party, securities held by the third party for UCITS are unavailable for distribution among or realisation for the benefit of creditors of the third party.

UCITS V Implementing Measures

The Commission has published implementing measures under UCITS V, providing further detail on the rules applicable to UCITS depositaries (the “**Level 2 Regulation**”). The Level 2 Regulation provides further detail in relation to the provisions to be included in the depositary contract, as well as the depositary’s initial and ongoing due diligence duties regarding the selection of a delegate and the rules for the segregation of assets.

We have prepared the summary table below to provide an overview of the requirements set out in the Level 2 Regulation.

Requirement	Description
Details of the written contract appointing the depositary	The Level 2 Regulation sets out the contractual particulars that must be included in the depositary agreement.
Depositary functions, due diligence duties, segregation obligation and insolvency protection	<p>General depositary duties: The Level 2 Regulation provides for detailed rules relating to the depositary’s duties with regard to: oversight; subscription and redemptions; the valuation of units; the carrying out of the UCITS’ instructions; the timely settlement of transactions; income calculation and distribution; and cash monitoring.</p> <p>Safekeeping: Further detail is provided in the Level 2 Regulation in relation to the financial instruments that can be held in custody and the depositary’s safekeeping duties with respect to those assets. The Regulation also specifies requirements relating to the depositary’s safekeeping duties regarding ownership verification and record keeping in respect of assets not held in custody.</p> <p>Due diligence: The Level 2 Regulation sets out the depositary’s initial and ongoing due diligence requirements regarding the selection of sub-depositaries and the segregation of assets.</p> <p>Insolvency protection: The Level 2 Regulation requires the depositary to ensure that delegates take steps to ensure the protection of UCITS’ assets against the insolvency of the delegate and to ensure that third country laws adequately provide for segregation of the UCITS’ assets.</p>
Loss of financial instruments and liability discharge	The Level 2 Regulation specifies the conditions under which a loss of a financial instrument held in custody will be deemed to occur and the conditions under which the depositary’s liability will not be triggered.
Independence requirements and provisions regarding the appointment of the depositary, conflicts of interest and the independence of management boards and supervisory functions	<p>Independence: The Level 2 Regulation includes this requirement to ensure the operational independence of the depositary and the UCITS or UCITS management company.</p> <p>Appointment of depositary: The Level 2 Regulation includes the requirement for a UCITS or UCITS management company to put in place a robust decision making process for choosing the depositary which must be based on objective pre-defined criteria meeting the sole interest of the UCITS and its investors. This requirement applies equally upon any delegation by the depositary.</p> <p>Conflicts of interest: The UCITS / its management company and the depositary must put in place policies and procedures regarding conflicts of interest where a link (as defined in the Level 2 Regulation) exists between them or where they belong to the same group.</p>

Independence of management boards and supervisory functions: The Level 2 Regulation sets out requirements in respect of a minimum number of independent members of the management body of the management company / depositary or the body in charge of the supervisory functions within the management company / depositary, where the UCITS or its management company and the depositary belong to the same group.

Comment

One of the impetuses behind the introduction of UCITS V was the “credit crisis” and the desire to align the UCITS framework with the AIFMD. Whilst both the AIFMD and UCITS V are broadly similar in approach in relation to the requirements for the depositaries, there are differences which are to be expected due to the focus of UCITS V on retail investors. UCITS V provides depositaries with additional challenges over and above those experienced under the AIFMD.

If you require detailed advice relating to UCITS V, please get in touch with your usual Asset Management and Investment Funds Group contact or any of the contacts listed in this publication. Further briefing notes and updates on UCITS V may be accessed on our [website](http://www.matheson.com).

Full details of the Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team, can be accessed at www.matheson.com.

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