



Monday, 5 November 2018

## AIF & UCITS depositaries: heightened duties when delegating

Two new regulations have been published amending existing Level 2 requirements on depositaries of AIFs and UCITS with effect from 1 April 2020. They impose stricter obligations on them when they delegate their safekeeping obligations to a third party custodian. In substance, the two amending Regulations are broadly identical to one another.

The following regulations were published in the Official Journal on 30 October 2018:

[Commission Delegated Regulation \(EU\) 2018/1618](#) which amends the safekeeping provisions of Delegated Regulation (EU) No. 231/2013 (the AIFMD Level 2 Delegated Regulation); and

[Commission Delegated Regulation \(EU\) 2018/1619](#) which amends the safekeeping provisions Delegated Regulation (EU) 2016/438 (the UCITS Level 2 Delegated Regulation).

Although both amending Regulations will come into force in a couple of weeks, on 19 November 2018, depositaries have been given eighteen months in which to make the necessary changes to their arrangements with third party delegates.

These changes will not have a direct impact on AIFMs and UCITS managers. However, such managers will need to consider whether any changes are necessary to the terms of their existing depositary agreements in order to reflect in the contract the depositary's new and enhanced obligations under regulation.

For depositaries some of the new, more detailed requirements are likely to be onerous. Managers should therefore be aware of the forthcoming changes and alive to attempts by depositaries to increase their fees as a way of recouping the additional costs they may incur in preparing for the more stringent requirements.

### SUMMARY

The changes will apply to depositaries of AIFs and UCITS when delegating their safekeeping functions to a third party custodian. In summary, they will:

- clarify how the frequency of the depositary's reconciliations between its own books and those of its appointed third party custodian should be determined;

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- impose specific requirements which the depositary must ensure are incorporated in its delegation agreement with the third party custodian in terms of information on, and access to, the third party's records; and
- require the depositary to:
  - ensure and verify that the third party custodian complies with specific segregation requirements; and
  - obtain independent legal advice that insolvency law will not undermine the protections of segregation where the third party is located in a third country.

The same requirements will apply to any sub-custodian to which the third party custodian has delegated its safekeeping duties.

It should be noted that these changes will apply to UK depositaries even if there is a "hard" Brexit and no transitional period is agreed with the EU. As it currently stands, in the event of "no deal", the AIFMD and UCITS Level 2 Regulations, as amended, will be "onshored" by the UK as of 29 March 2019 ("exit day") and will form part of UK law as "retained EU law" on and after that day. This is the effect of the European Union (Withdrawal) Act 2018. If a deal is agreed, the changes will become directly applicable during the transitional period and the "onshoring" of the Regulations will simply be postponed to the end of the transitional period (expected to be 31 December 2020).

Either way, therefore, UK depositaries will be required to comply with the enhanced requirements as from 1 April 2020.

## THE CHANGES IN DETAIL

The changes will apply to depositaries of AIFs and UCITS when delegating their safekeeping functions to a third party custodian.

### DEPOSITARY'S RECONCILIATIONS

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Rather than "regular" reconciliations, depositaries will be required to conduct reconciliations "as often as necessary" between their own internal accounts and records and those of any third party custodian to whom they have delegated safekeeping functions. The frequency is to be determined by reference to the normal trading activity of the AIF or UCITS, any trade outside that normal trading activity and any trade on behalf of another client whose assets are held by the third party custodian in the same "omnibus" account as the assets of the AIF or UCITS.

### CONTRACTUAL REQUIREMENTS APPLICABLE TO THE DELEGATION

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As part of the depositary's due diligence obligations, it will have to ensure that its contract with the third party custodian contains at least:

- provisions which guarantee its right to information, inspection and access to the sub-custodian's records and accounts to enable the depositary to fulfil its oversight and due diligence obligations and which, in particular, allow it to:
  - identify all entities within the custody chain;
  - verify that the quantity of assets recorded on its books in the name of the AIF or UCITS (or in the name of the AIFM or UCITS manager on behalf of the fund) matches the quantity of assets held in custody by the third party custodian as recorded on its books for that fund;
  - verify that the quantity of assets which are registered and held in an account opened at the issuer's CSD or its agent, in the name of the third party custodian on behalf of its clients, matches the quantity of

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assets recorded on the depositary's books in the name of the AIF or UCITS (or in the name of the AIFM or UCITS manager on behalf of the fund);

- details of equivalent rights and obligations agreed between the third party custodian and another third party (i.e. a sub-custodian) in the event of a further sub-delegation of safekeeping. In practice, this means that the agreement between the depositary and the third party custodian should indicate whether the latter is permitted to further sub-delegate its obligations; and, if it is, the depositary is likely to want to make the sub-custodian subject to contractual provisions equivalent to those to which the third party custodian is subject.

Depositaries will need to revisit any delegation arrangements with their third party custodians and negotiate amendments where necessary to comply with the new changes.

## SEGREGATION BY THE THIRD PARTY CUSTODIAN (WHEREVER LOCATED)

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The existing requirements as to segregation under the AIFMD and UCITS Level 2 Delegated Regulations will be enhanced and subject to further specification (although for depositaries of UCITS some of these requirements are already in place to an extent – see below). Over and above the current requirements, the depositary will be under an obligation, on a partial or full delegation of its safekeeping functions, to *ensure and verify* that its appointed third party custodian:

- correctly records all identified financial instruments in the account which the third party custodian has opened in its books to hold in custody the financial instruments for the depositary's clients – this "omnibus" account in the name of the depositary can include AIF and UCITS assets belonging to the depositary's clients, but must exclude proprietary financial instruments which belong to the depositary, the third party custodian or to the other clients of the third party custodian. This record of account must enable the depositary to match the quantity of financial instruments recorded in *its* books in the name of each of its AIF or UCITS clients (or in the name of the AIFM or UCITS management company acting on behalf of the fund);
- maintains records and accounts in a way that ensures their accuracy, and in particular their correspondence to the assets kept safe for the depositary's clients (as now) but also (going forward) on the basis of which the depositary can at any time establish the *precise nature, location and ownership status of the assets* (depositaries of UCITS are already subject to this obligation when delegating to a third party custodian located in a third country);
- provides the depositary with a statement on a regular basis, and whenever a change in circumstances occurs, detailing the assets of the depositary's clients (depositaries of UCITS are already subject to this obligation when delegating to a third party custodian located in a third country); and
- conducts reconciliations "as often as necessary", the frequency to be determined on the same basis that applies to the depositary (see above).

If the depositary agrees that its third party custodian may sub-delegate, these additional requirements will apply to the sub-delegated arrangements, so the depositary will want to ensure that it imposes appropriate contractual obligations on the third party custodian.

## SEGREGATION BY A THIRD COUNTRY CUSTODIAN (LOCATED IN A THIRD COUNTRY) – ADDITIONAL INSOLVENCY PROTECTION REQUIREMENTS

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In addition to the above, when it is delegating to a third party custodian located in a third country, a depositary will also have to meet additional obligations (depositaries of UCITS are for the most part already subject to these). These are that:

- it receives independent legal advice confirming that the insolvency law in that third country recognises
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- the segregation of assets;
- that the assets of the depositary's AIF or UCITS clients do not form part of the estate of the third party custodian in the event of its insolvency; and
- those assets are not available for distribution to/realisation by the creditors of the third party custodian;
- the third party custodian ensures that the conditions above are met (both at the time of concluding the delegation agreement and on an ongoing basis) and, if any of those conditions are no longer met, it will immediately notify the depositary; and
- the third party custodian will immediately inform the depositary about any changes to applicable insolvency law and its application.

Again, these additional requirements apply in the event of a sub-delegation by the third party custodian.

As regards the last two bullet points, the depositary will likely need to include contractual provisions in its delegation agreement designed to procure that the sub-custodian complies.

It should be noted that, following Brexit, any UK third party custodian appointed by an EEA depositary will be located in a third country from the perspective of the EU legislation. By the same token, from the perspective of a UK depositary any jurisdiction outside the UK, including any EU country, will be a "third country" for the purposes of the onshored version of the Regulations (as "corrected").

## FOR FURTHER INFORMATION, PLEASE CONTACT

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