

November 2016

Update on the provisions applicable to depositaries of UCITS and Part II funds.

I. REGIME APPLICABLE TO UCITS FUNDS

On 11 October 2016, the CSSF published Circular 16/644 relating to the provisions applicable to credit institutions acting as UCITS depositaries, to UCITS funds themselves and, where applicable, to their management companies (the “new Circular”).

Not surprisingly, the new Circular does not bring any major change but brushes up Circular 14/587.

The first noticeable point is that the Circular has considerably been shortened to avoid overlap with the applicable Commission Delegated Regulation (EU) 2016/438 of 17 December 2015 (e.g. the details which are to be included in the written contract of a depositary¹, description of the monitoring duties², elements regarding the accounting and proper monitoring of cash flows³).

You will find below a summary of the most important points which are addressed:

- **Requirement of CSSF approval for any fundamental change⁴**

The new Circular stipulates that all credit institutions acting as UCITS depositary are required to request approval to the CSSF for any fundamental change of the information that was the basis of their initial approval as a UCITS depositary. “Fundamental change” has to be understood as including any change concerning material aspects of delegation and outsourcing of a material activity as well as any fundamental change of the depositary’s operational model.

- **Specific provisions regarding outsourcing⁵**

The new Circular clarifies the distinction between the delegation of the safekeeping duty to a third party and the outsourcing of part or all operational tasks or activities or services to a third party and further provides

¹ Appendix 1 p.54 of CSSF Circular 14/587

² Part IV, Chapter 2, p.28 of CSSF Circular 16/644

³ Part III, Subchapter 3.7, p.21

⁴ Part II, Subchapter 2.2, paragraph 10, p.11 of CSSF Circular 16/644

⁵ Part II, Sub-Chapter 2.3, p.11-12 of CSSF Circular 16/644

specifications on the rules to be complied with in relation to outsourcing of material activities.

When outsourcing an activity considered as “material”, depositaries must ensure that the risk management policies and procedures put in place identify in an appropriate manner the risks relating to the outsourcing. A “material” activity has to be understood as an activity that, if not properly performed, decreases the capability of the depositary to comply with the regulatory requirements or to pursue its operations as well as any activity necessary to a sound and prudent management of risks.

The new Circular also mentions that any outsourcing is subject to a contract. The contract must contain a provision granting the CSSF access to the premises of the entity to which a material activity has been delegated. The entity to which it is outsourced must be subject to Circular 12/552 and any outsourcing of a material task must be approved by the CSSF. This approval is however replaced by a mere notification in the case of outsourcing to a Luxembourg credit institution, or to a Support Professional of the Financial Sector.

- **Provisions relating to due diligence and delegation of safe-keeping function⁶**

With regards to the due diligence procedure that must be put in place by the depositary delegating its safe-keeping functions, the new Circular specifies that this procedure should be reviewed regularly (i.e. at least once a year) and made available to the CSSF upon request. The internal audit and the internal control department of the depositary will be in charge of controlling the existence and effective implementation of this procedure.

- **Applicable law and jurisdiction clause in the depositary agreement⁷**

The new Circular recalls that there must be a specific provision in the depositary agreement highlighting that it is to be governed by the law of the Grand-Duchy of Luxembourg. The new Circular provides that any conflicts between the contractual parties should be subject to the jurisdiction of Luxembourg courts, the latter is a recommendation only.

- **Removal of the provisions relating to “prime broker”⁸**

All provisions contained in the new Circular referring to the organisational requirements of the depositary and the UCITS in the case a prime broker is used have been deleted. It was felt that the term “prime broker” was improperly used in a UCITS context, where UCITS rather have recourse to executing or clearing brokers (e.g. who do not keep any fund assets) as opposed to genuine prime brokers. Further, given the restrictions introduced by the UCITS V Directive concerning the reuse of UCITS’ assets by the depositary or by any third party to which the custody function has been

⁶ Part III, Chapter 3.3, p.19

⁷ Part II, Chapter 3, p.12

⁸ Part III, Chapter 1, p.16, Part IV Sub-Chapter 7.3 p.36-39 and Appendix 3 p.61

delegated (e.g. prime broker), it was difficult to see a necessity for provisions relating to (true) prime brokers in the new Circular.

- **Specific provisions relating to the escalation procedure⁹**

According to the new Circular, even though the main principles of the escalation procedure have to be included in the depositary agreement, the details of the escalation procedure can be laid down in other more easily editable documents (i.e. service level agreement or operating memorandum).

- **New provisions relating to the requirements of contingency plans¹⁰**

The new Circular broadens the scope of the depositary's contingency plan. Previously, the contingency plan needed to address potential insolvency situations of the delegates. The contingency plan must now include any event likely to interrupt the ability of the depositary to provide its services to its UCITS clients.

- **Update of the list of information relating to the functions of the depositary of UCITS which must be kept up-to-date and provided to the CSSF on a periodical, punctual or annual basis¹¹**

The list of information to be provided to the CSSF has been amended:

- the list of sub-custodians appointed by the depositary for the safekeeping of assets can be either provided to the CSSF on an annual basis or an updated list of the sub-custodians can be made available on a website;
- the auditor's report on the adequacy of the depositary's organisation is no longer required by the CSSF;
- the description of the compliance section to be provided on an annual basis is no longer required by the CSSF;
- the new Circular also specifies that annual information must be filed with the CSSF at the latest six months after the closure of the financial accounts of the depositary.

II. REGIME APPLICABLE TO PART II FUNDS

As a reminder, since the implementation of the UCITS V Directive into Luxembourg law¹², the UCITS depositary regime has been extended to all Part II funds, whether managed by an authorised AIFM, or by a registered AIFM.

This provision has introduced some uncertainties in the fund industry. On 29 July 2016, draft bill 7024 was deposited with the Luxembourg Parliament to bring more clarity.

⁹ Part III, Chapter 5, p.23

¹⁰ Part III, Chapter 8, p.27

¹¹ Appendix 1 p.32 of CSSF Circular 16/644

¹² Law of 10 May 2016 transposing Directive 2014/91/EU

Once adopted, a distinction will be made in relation to the depositary regime applicable to Part II funds. Only Part II funds managed by an authorised AIFM or by a registered AIFM that are distributed to retail investors on Luxembourg territory will fall under the UCITS V depositary regime. Other Part II funds will remain subject either to the law of 12 July 2013 on alternative fund managers, if managed by an authorised AIFM, or to the law of 13 February 2007 on specialised investment funds, if managed by a registered manager.

According to the commentary of the relevant article of the draft bill, the issue documents must expressly provide that the units of the Part II fund are exclusively marketed to professional investors within the meaning of MiFID and MiFID II.

The new Circular does not make any reference to the depositary regime of Part II Funds.

III. WHAT'S NEXT?

The new Circular came into force at the same time than the Level 2 measures (i.e., 13 of October 2016) and may be amended in the future if new guidance were to be published by ESMA (e.g. ESMA guidelines on asset and custody services which could be published by the end of 2016).

Should you have any questions on the above information, we invite you to liaise with any of the contacts provided or your usual Linklaters contact.

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