association of the luxembourg fund industry

Association des Banques et Banquiers, Luxembourg
The Luxembourg Bankers' Association
Luxemburger Bankenvereinigung

Depositary Bank Forum

Analysis of the draft Commission Delegated Regulation published on 29 May 2018 in relation to safekeeping duties of depositaries for AIFs and UCITS clients' assets and amending regulations 2013/231 and 2016/648

26 June 2018

Introduction

Scope of the proposed drafts and the related consultations

Stakes and objectives of the draft CDRs

On 29 May 2018, the EU Commission published **two awaited draft Delegated Regulations amending the current Commission Delegated Regulations (EU) 2013/231 and 2016/438 in relation to safe-keeping of AIF and UCITS clients' assets** (the ''**draft CDRs**'' hereinafter).

The amendments proposed in the draft CDRs apply only **where a depositary delegates safe-keeping functions to third parties** (custodians).

The proposals follow up on the opinion on asset segregation and application of depositary delegation rules to CSDs issued by the European Securities and Markets Authority (ESMA) on 20 July 2017 (ESMA34-45-277). **ESMA identified therein, *inter alia*, issues where the understanding among stakeholders differs and invited the Commission to clarify certain obligations of depositaries in case they delegate safe-keeping functions to third parties**. ESMA proposed that the asset segregation requirements be better defined and complemented by additional safeguards, in particular the requirements to contractually ensure a sufficient flow of information between the depositary and the custodian or sub-custodian.

Content of the drafts

(5 amendments detailed in the next pages)

*Draft **1** amending delegated regulation* **(EU) 2013/231 re. AIF clients' assets**

https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-2778659_en

*Draft **2** amending delegated regulation* **(EU) 2016/438 re. UCITS clients' assets**

https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-2778673_en

The two draft CDRs are similar in terms of structure and content, except for aspects in relation to non-EU delegates:

-2013/231 (AIF) has dedicated provisions for non-EU delegates.

-2016/438 (UCITS) does not include specific provisions for non-EU delegates.

Prior consultations

- While developing its opinion, ESMA consulted the public twice:
  - from 1 December 2014 to 30 January 2015, and
  - from 21 June to 23 September 2016.
- ALFI responded to both of these consultations (see Annex 1).
- The Commission has based its work on ESMA's opinion of 20 July 2017 and the Commission did not conduct another public consultation prior to drafting this proposal.

Executive summary

The below text is a copy of the main message posted on the "better regulation" feed-back portail

The Luxembourg depositary banking sector, represented for the purposes of this feedback by ALFI and ABBL, welcomes the European Commission's initiative to follow up on the ESMA opinion and is happy to provide feedback as per the attached document in regard of the different proposals made. We understand that, as stated in Part 1 of the Explanatory Memorandum, the European Commission aims, with this initiative, at harmonising insolvency laws at EU level in order to ensure protection of assets safe-kept by depositaries or custodians for their clients.

Firstly, we consider that a depositary should be able to rely on the record-keeping of its delegate when delegating safe-keeping functions. There is no practical reason for the depositary to maintain a custody record that is already recorded and reconciled in the books of its delegate. This model, known in the industry as ''reliance model'' has a proven track record in a number of jurisdictions. Moreover, we are not aware of any case of depositary failure in the European Union. As such, the reliance model coupled with the strong liability regime applicable to depositaries provide, in our view, enough protection for the assets safe-kept by depositaries or custodians for their clients.

Secondly, the draft CDRs propose implementing one single standard of challenging operational procedures. This proposal leaves without consideration the practical organisation of the custody chain which not only differs from one jurisdiction to another, but also and most importantly depending on type of underlying asset. While some of these provisions presented in the draft CDRs were suggested and hinted at in the ESMA opinion, ESMA certainly being aware of these national and asset-based discrepancies, did not provide at the time a clear description of the full contemplated set-up. As such, we strongly suggest to retain the current risk-based approach proper to and conscious of each custody model.

Thirdly, we deem that the scope of a depositary's safe-keeping versus its record-keeping obligations should be reviewed. As such, it is crucial to maintain the main focus on the depositary's responsibilities for the financial instruments that can be technically safe kept rather than extending the safe-keeping responsibilities to any type of asset, thereby including assets that cannot technically be safe-kept. For these assets, the solution of choice needs to be record-keeping taking into account that this is the only solution technically possible.

We further believe that harmonised safe-keeping provisions that apply to assets that cannot technically be safe kept do not take into account the operational reality of the custody functions. To such extent this does not provide additional safeguards for the end-investor. In addition, if the draft CDRs were approved as such, these new requirements would become applicable in the first quarter of 2019. This very short timeline cannot be met in terms of implementation of the corresponding operational processes without regression and impacts on the current conduct of business.

Moreover, the draft proposal for independent legal advice on insolvency in CDR 2013/231 does not take into account the nuances typically found in such advice, and shifts the obligation to the depositary. We strongly suggest sticking in this respect to the current UCITS approach.

Conclusively, we consider that a restriction on the right of the depositary to delegate the maintenance of books and records is not beneficial to investors or the funds industry in general. It neither improves investor protection nor the asset safe-keeping controls. As such, it fails to match the Commission's asset segregation objectives. On the contrary, the current proposals would introduce market inefficiencies, as well as increase investor costs, thereby resulting in significant market disruption, including, for example, depositaries refusing any investment with a counterparty that cannot be mirrored.

Preliminary and general remarks on the draft CDRs

1. Scope of functions, assets and third parties covered by the amendments

Instead of referring to the the safe-keeping of clients assets, the draft CDRs should refer to the custody of financial instruments. Indeed, based on the current regulatory framework in place for depositaries and custodians, the safe-keeping of assets functions is not limited to the custody of financial instruments, but includes custody functions in regard of cash, which qualifies as other/non custodiable asset. In order to avoid any misleading and unintended consequences, we therefore strongly advocate to change the definitions and notions used in the draft CDRs.

Moreover, it is essential, in our view, that the draft CDRs clearly define the relevant scope of application for the types of third-parties aimed at. This is of particular relevance when considering whether global custodians come within the scope of application or not.

2. Record keeping - Number of accounts to implement

Another general remark applicable to both draft CDRs relates to the number of implemented accounts. Indeed, as already pointed out by ESMA in its opinion, increasing the number of accounts and records does not, *ipso facto*, increase asset protection for the clients. On the contrary, we believe that an increase in accounts and records is more likely to lead to consolidation issues in the mid-term and long-term.

3. Timeline for entry into force

The current proposed timeline for the entry into force of the draft CDRs is not aligned with any operational considerations.

As mentioned before, in case the draft CDRs were approved as they currently stand, the underlying provisions would become applicable as of the first quarter of 2019. It is very challenging for the depositary banking sector to align itself with the proposed requirements within such a short timeline, with corresponding operational processes not being fully implemented leading to regression and negative impacts on the current conduct of business.

As such, the proposed timeline does not give depositaries the time to implement the changes, which would have very severe consequences for UCITS, AIFs and their investors. For this reason, and based on the impact analysis performed by industry representatives, we request that this delegated regulation enters into force 24 months after its publication.

Amendment #1

Frequency of reconciliations

Articles of draft CDRs	
2013/231 AIF	**2016/438 UCITS**
Art. 89(1)	Art. 13(1) i. and ii.

1. Objective of the amendments

The proposed amendments suggest some factors determining the frequency of reconciliation between the depositary's financial instruments accounts and internal records against those of the third parties to which safe-keeping functions have been delegated. For such purpose, the depositary will need to take into account the trading frequency of the depositary's AIF/UCITS client as well as the trades carried out by other clients, whose assets are held in the same omnibus account.

The proposed amendments require that reconciliations are conducted as "frequently as necessary" between the depositary's internal accounts and records against those of third-party delegates.

2. Impact assessment

This requirement did not exist previously. At present, reconciliations are done "on a regular basis" and the draft requires reconciliations "as frequently as necessary".

While this elucidation does not, *per se*, seem to require more from the depositary than is currently required, the criteria provided for in articles 89(1)(c)(ii) of draft CDR 2013/231 and article 13(1)(c)(ii) of draft CDR 2016/438 specify the European Commmission's understanding of the frequency of reconciliations. Based thereon, there is a significant impact on the dedicated resources (human and system) required to design, implement and run the corresponding operational processes.

3. Arguments

a. The criteria driving the suggested reconciliation process are inherently subjective (e.g. "normal trading of activity"), and therefore likely to be challenged and interpreted differently by different stakeholders and/or in different jurisdictions.

b. The practical application of the criteria mentioned in the draft CDRs are difficult to apply in practice, to the extent that the omnibus accounts at stake here include, in most cases, UCITS, AIF's and other clients assets. It is virtually impossible to review the activity of a UCITS or AIF in isolation. This is further corroborated by the fact that the different types of clients consolidated in omnibus accounts may also have different types of investment strategies which makes the assessment even more difficult.

c. Reconciliation procedures will need to be designed in light of the type of underlying assets and relations (e.g. private equity, triparty repos) as well as take into consideration the relevant and specific depositary set-up (in particular, the number and type of delegates).

4. Proposal

1. The depositary banking industry we represent would encourage a potential alternative wording focusing on a risk-based approach that takes into account the level of segregation already in place. This is much more in line with the practical reality than focusing on the trading pattern.

2. We stronly suggest to remove the three criteria proposed in the current draft articles 89(1)(c)(ii) of draft CDR 2013/231 and 13(1)(c)(ii) of draft CDR 2016/438.

Amendment #2

Depositary books and records

Articles of the drafts	
2013/231 AIF	**2016/438 UCITS**
Art. 89(2)	Art. 13(2)

1. Objective of the amendments

The proposed amendments require that depositaries maintain a record in their respective financial instruments account opened in the name of an AIF /UCITS client or in the name of the AIFM/Management company acting on behalf of the AIF/UCITS **showing that the assets kept in custody by a third party belong to a particular AIF/UCITS client**.

As such, the depositary is required to have, at all times, a complete overview of the assets of its AIF/UCITS clients where the custody of assets has been delegated to a third party.

2. Impact assessment

The proposed amendments refer to the notion of "depositary's internal accounts and records". This reference implies that the depositary is required to effectively maintain books and records for all the financial instruments held in custody, including the ones held directly by sub-custodians (e.g. prime brokers and collateral agents) for which accounts have been opened not only in the name of the depositary but also in the name of the fund.

Applying the proposed provisions would require depositaries' to replicate in their books the records held by the delegate(s) with dedicated feeds, which is an enormous organisational and practical issue for the depositary banking industry.

3. Arguments

a. The proposed amendments in articles 89(2) of draft CDR 2013/231 and 13(2) of draft CDR 2016/438 come as a surprise, as they were not included as such in the ESMA opinion. The ESMA opinion did not provide enough granularity in its articles 75 and 78 to legimitately expect the deep-impacting changes proposed by the European Commission.

b. A proper cost/benefit analysis will need to be conducted on this point, given the very significant impact these proposed amendments will have on the industry. ABBL and ALFI have also made similar comments in the recent initiatives relating the AIFMD review process.

c. As mentioned before, increasing the number of accounts does not, *ipso facto*, lead to a linear increase of the protection of the assets.

d. While the proposed amendments may have less impact for some jurisdictions, it is essential that the EC recognises the diversity of the depositary banking industry within the EU and provides for required flexibility.

e. The currently applied risk-based approach pursuant to which a depositary appoints and monitors the delegates has a proven track record. We kindly refer to Annex 2 hereto for more details of the current model's effectiveness and efficiency.

4. Proposal

Based on industry feedback received, we propose the following alternative wording in relation to the book and records:
"To satisfy its safe-keeping obligations in regards to the books and records and segregation when financial instruments are held with a third-party (e.g. prime broker or collateral safekeeping agent), the depositary may rely on the books of the third-party".

Amendment #3

Identification of all entities in the custody chain and implications on the reconciliation processes

Articles of the drafts	
2013/231 AIF	**2016/438 UCITS**
Art. 98(2a)	Art. 15(2a)

1. Objective of the amendment

The proposed amendments list the minimum detail that should feature in the contractual documentation between the depositary and its third-party in relation to the delegation of custody of assets of the depositary's AIF/UCITS clients. Based thereon, **the depositary must be able to identify all the entities in the custody chain and secure access to all the relevant information** in the third party's possession to be able to **verify the quantity of the identified financial instruments** kept in custody by the third party. Should the third party need to delegate the custody function to another third party, the proposed amendments require the delegating third party to contractually secure equivalent rights from that another third party, as itself granted to the depositary.

2. Impact assessment

a. The proposed amendments requires to identify all entities within the custody chain. The first question in this context relates to the definition of identification, i.e. how far the depositary would need to go in terms of identification. Any particularly wide interpretation of this notion would entail significant practical constraints. Secondly, and regardless of the scope of identification, any information relating to the entities in the custody is not necessarily available off-the-shelf and can significantly vary from one client to another (e.g. using directed sub-custodians). This is further complexified in light of the concept of look-through, even where depositaries may only appoint as delegates entities holding financial instrument held in custody on an account open in the name of the fund or the management company of the fund on behalf of the fund. This new requirement could create significant administrative burden in terms of updating the contractual documentation on a timely basis.

b. In relation to article 98(2a)(a)(ii) and (iii) of draft CDR 2013/231 and article 15(2a)(a)(ii) and (iii), it is not clear why it is necessary to include any operational control procedures in the contractual documentation. More fundamentally, the current draft texts are not necessarily consistent, insofar as the reconciliation at the level of the delegate(s) and CSDs are, on the basis of the draft CDRs, carried out at omnibus level. Accordingly, there is no distinction per product type. Moreover, differences may also occur as a result of the timetable or processing issues. The current draft proposal does not take these practical issues into account. As mentioned, it is essential in this context that reconciliations at the AIF level remain high-level, as suggested by the ESMA opinion.

3. Arguments

a. The current draft proposals for articles 98(2a) of the draft CDR 2013/231 and 15(2a) of draft CDR 2016/438 differ from the litteral reading of the ESMA opinion and go beyond what could have been reasonably expected from the ESMA opinion.

b. A proper cost/benefit analysis will need to be conducted on this point, given the very significant impact these proposed amendments will have on the industry. It is further not clarified to whom the requested information should be provided.

c. The current draft proposals do not match current operational procedures in place. Implementing the proposed standards cannot be standardised in light of the variety of delegation models used and impacted concerned.

4. Proposal

1. *Based on industry feedback received, we propose the following alternative wording:*
"The depositary should be able to provide to the authorities the list of entities appointed by the depositary".

2. *Based on industry feedback received, we propose the following alternative wording in relation to* article 98(2a)(a)(ii) and (iii) of draft CDR 2013/231 and article 15(2a)(a)(ii) and (iii)*:*
"The depositary should ensure that there are, throughout the custody chain, appropriate and effective control procedures in place in relation to the reconciliation of the financial instruments held at the level of the delegates and CSDs. Due diligences are part of these procedures."

Amendment #4

Enlarged scope of assets in the custodian omnibus account

Articles of the Drafts	
2013/231 AIF	**2016/438 UCITS**
Art. 99(1)	Art. 16

1. Objective of the amendment

The proposed amendments aim at clarifying the asset segregation requirements for third parties (custodians) to which the custody of AIFs/UCITS assets has been entrusted. **A custodian can hold assets of UCITS and AIFs clients and other clients of one depositary in the same omnibus account**, provided its own assets, proprietary assets of the depositary and assets belonging to other clients of the third party are held in segregated financial instruments accounts. To ensure increased asset protection and facilitate the depositary's oversight duty for the entrusted assets, custodians must issue depositories with a statement whenever a change relating to the safe-kept assets occurs. New technological solutions might be particularly helpful in facilitating this process. Factors to determine the frequency of reconciliation mirrors those set out in the amendment to articles 89(1)(c) of draft CDR 2013/231 and 13(1)(c) of draft CDR 2016/438.

2. Impact assessment

1. The proposed draft CDRs introduce a more granular view on the assets that can be held in an omnibus account, that should be considered as the minimum requirement.

2. The new provisions set out in the proposed article 99(1)(f) of draft CDR 2013/231 and article 16(1)(f) of draft CDR 2016/438 are already mentioned in article 99(1)(d) of the current CDR 2013/231 and article 16(1)(d) of the current CDR 2016/438 and thereby go beyond the ESMA opinion proposal.

3. Arguments and proposals

Considering that, in our view, the proposed amendments to articles 99(1) of CDR 2013/231 and 16(1) of CDR 2016/438 go beyond the requirements set out in the ESMA opinion, we propose to, at least, remove the reference in article 99(1)(f) of draft CDR 2013/231 and article 16(1)(f) of draft CDR 2016/438.

Additionnally, and cross-referring to the comments made with respect to Amendment #3, when using a single omnibus account, the quantity matching should apply per AIF/UCITS client.

Amendment #5

Obligations when delegation outside the EU (Insolvency law)

Articles of the Drafts	
2013/231 AIF	**2016/438 UCITS**
Art. 99(2a)	**N/A**

1. Objective of the amendment

- ***For AIFs***

The proposed modifications to Article 99(2a)(a) of CDR 2013/231 introduces new requirements for depositaries delegating the custody of assets to third parties located outside the EU. As such, depositaries would be required to seek **legal advice from independent parties on the insolvency laws of the third country**. The depositaries should also make sure that the relevant third party complies with their national laws securing the benefits of asset segregation and the third party communicates any modifications to the applicable insolvency laws within the legal system in which they are operating.

- ***For UCITS***

The draft CDR 2016/438 deletes sub-paragraphs (d) and (e) of article 17(2) as well as paragraph (3) of Article 17. These provisions are however consolidated into article 16(1) of the draft CDR 2016/438 relating to the record-keeping obligations and transmission to the depositaries of relevant information affecting the status of safe-kept UCITS assets. This is relevant for the depositaries' monitoring of assets safe-kept by any third party to whom this function has been entrusted, regardless of whether the third party is located inside or outside the EU.

2. Impact assessment

1. The requirement for legal advice from independent parties on the insolvency laws of the third country set out in the revised article 99(2a)(a) of draft CDR 2013/231 is unrealistic, in our view. These types of legal opinions are usually too nuanced to cover the proposed paragraph 2a(a) and hence this type of legal will consistently fall short of the standard set by article 99(2a)(a) of draft CDR 2013/231. This issue is further corroborated by article 99(2a)(a) expecting that the delegate ensures the legal advice conditions are met at all times, which is again unrealistic due to the legal nuances.

2. The new requirements for AIFs shifts the obligation to the depositary against its delegate, whereas for UCITS, the obligation remains with the delegate against its depositary.

3. The proposed texts furthermore refer to "assets" rather than "financial instruments". This is problematic insofar as the proposed draft CDRs have been proposed in the context of the safe-keeping of financial instruments. This explicitly excludes, for the avoidance of doubt, any so-called "other assets" (e.g., in particular in this context, cash and any other fungible assets).

3. Arguments

Different regimes for AIFs and UCITS in the context of delegation to non-EU third parties have a significant impact on the depositary banking industry by complicating the depositaries' mission.

4. Proposal

1. Based on the industry feedback received, we strongly advocate for aligning the AIF regime for delegating to non-EU third parties on the existing UCITS regime, thereby significantly facilitating the mission of the depositary as it can rely on already existing procedures.

2. As mentioned above, the reference to "assets" rather than "financial instruments" goes beyond the intended scope of the draft CDRs and should therefore be replaced.

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Annexes

Annex 1
ESMA opinion of July 2017 and previous consultations

Rationale

On 20 July 2017, ESMA has issued an opinion on asset Segregation and applying Depositary delegation rules to CSD.

https://www.esma.europa.eu/press-news/esma-news/esma-publishes-opinion-asset-segregation-and-applying-depositary-delegation

The European Securities and Markets Authority (ESMA) has published an opinion to the European Commission, the Council and the Parliament (EU institutions) under Article 34 of the ESMA Regulation.

The opinion sets out suggestions to the EU institutions for possible clarifications of the legislative provisions under both Directive 2011/61/EU (AIFMD) and Directive 2009/65/EC (UCITS) relating to:

a. the asset segregation requirements in case of delegation of safe-keeping duties by the appointed depositary of a fund (UCITS or AIF); and

b. the application of depositary delegation rules to CSDs, in the cases of issuer CSD or investor CSD.

ESMA indicates 2 objectives for this opinion:

1. to provide an EU framework with strong client asset protection, especially in insolvency, for the safe-keeping of assets which are, in accordance with both AIFMD and UCITS Directive, required to be held in custody, and

2. to provide clarification in the AIFMD and UCITS Directive regarding the application of the relevant depositary rules in the case of CSDs, ensuring a consistent approach across the EU.

This opinion is the final step of the work on these topics which began with the 2 below papers to which ALFI has answered.

To exploit during the analysis

Consultation paper (ESMA/2014/1326)

Issued on 1 December 2014.
⇒ ALFI's response:
http://www.alfi.lu/sites/alfi.lu/files/files/Alfi%20guidelines%20and%20recommendations/ALFI-response-on-ESMA-Consultation-Paper-Guidelines-on-asset-segregation-under-the-AIFMD.pdf

Call for evidence (ESMA/2016/1137)

Issued on 15 July 2016.
⇒ ALFI's response:
https://www.esma.europa.eu/file/19791/download?token=VIFOnQXc

Current Context

This opinion has been called for several years and is coming late.

Between the different players, not the same approach was chosen to implement record-keeping structures.

Annex 2
Effectiveness of the current delegation model

1. Responsibility of the depositary

Under the Delegation Model, the Depositary ensures its legal responsibility is fulfilled by virtue of:

(i) the Depositary's continued performance of its express duty under Art 89/13 to ensure the Financial Instruments are properly registered and that such record is accurately maintained (satisfied by points (ii), (iii), (iv) and (v));

(ii) the due diligence oversight performed by the Depositary upon appointment and on an on-going basis in respect of the Delegate, which ensures the Delegate's controls, processes and procedures with respect to the registration of the Financial Instruments and the maintenance of the record of Financial Instruments is satisfactory;

(iii) the Depositary's continuous right of access to the Delegate's record without undue delay and by extension, the ability to possess the Delegate's record;

(iv) the Depositary's contractual controls in place to ensure the Delegate's performance is to a standard that meets the AIFM/UCITS Regulations and affords the Depositary the right to terminate any Delegate appointment, in the event the Depositary is not satisfied with the Delegate's performance; and

(v) the near strict statutory liability retained by the Depositary in respect of the obligations performed by its Delegate;

Accordingly, the above safeguards enable the Depositary to be satisfied that the Financial Instruments are properly registered and accurately maintained in satisfaction of its obligations.

2. Detail of the actions performed by the depositary to satisfy its books and records obligations

(i) *Oversight of the delegate:* due diligence as required under the Directives / Regulations

(ii) *Accessibility of the delegate record:* contractually agreed to get instantaneous online access to the books and records of the delegate

(iii) *Contractual safeguards:* rights to visit and inspect the delegate and to oversee the performance of its duties; right of access to all required information, etc.