

# Regulatory Update Alert AIFs and UCITS: New Depositary Safekeeping Rules

**Angelos Onisiforou**  
Senior Associate

March 2020



PATRIKIOS PAVLOU  
& ASSOCIATES LLC

ADVOCATES - LEGAL CONSULTANTS

The Alternative Investment Fund Managers Directive (“AIFMD”) has been widely regarded by European regulators and industry players alike, as a very powerful and proficient tool, responsible for the establishment of a coherent and integrated legislative framework amongst Member States in the European Union.

As with every legislative instrument, time has come for further fine tuning and clarification. Accordingly, on the 16<sup>th</sup> of April 2019, the European Parliament voted a new set of regulations with the aim being to tackle some of the issues identified within ESMA’s report on the 20 of July 2017.

More specifically, the measures introduced cover four categories and aim to strengthen the Depositaries’ position in case where a Depositary elects to delegate its safe keeping functions.

The new set of rules is contained within the following legislative instruments:

1. Commission Delegated Regulation (EU) 2018/1618 which amends the safekeeping provisions of Delegated Regulation (EU) 231/2013; and
2. Commission Delegated Regulation (EU) 2018/1619 which amends the safekeeping provisions Delegated Regulation (EU) 2016/438.

(collectively referred to as the “Regulations”)

The deadline for complying with the above has been fixed for the **1<sup>st</sup> of April 2020** whereby, all Depositaries of AIFs and UCITS need to comply with the legislative requirements contained in the said Regulations.

*“The reasons behind this initiative”*

Both Regulations came as a direct response to the problem of differing and in some cases contradictory national securities and insolvency laws which currently exist at European Union level. This diversity amongst Member States in the European Union creates a divergence in the level of protection for financial instruments held in custody for AIFs and UCITS and poses significant hazards in the fund industry sector.

As it becomes clear from the Regulations, coherent rules are being introduced with the underlying purpose being the provision to Depositaries of the necessary tools and statutory power to supervise third party delegates more efficiently and effectively.

As many will agree, by strengthening the position of the Depositaries vis-à-vis third-party delegates, better investor protection is achieved, and further targeted safeguards are being introduced for the better safekeeping of assets.

*“The changes introduced”*

### Reconciliations

Reconciliations’ must be conducted as frequently as necessary between the Depositary’s internal accounts and records and those of any third party to whom safekeeping has been delegated.

The frequency of the reconciliations shall be determined on the basis of the following:

- a) the normal trading activity of the AIF/UCIT;
- b) any trade occurring outside the normal trading activity; and

- c) any trade occurring on behalf of any other client whose assets are held by the third party in the same financial instruments account as the assets of the AIF/UCIT.

As the Regulations specify this measure has been introduced in order to minimize the lack of loss of assets held in omnibus financial accounts provided by third parties to whom the custody function has been delegated.

### The Contract of Delegation

The delegation relationship should be documented by a written contract. The contract should allow the Depository to take all necessary steps ensuring that the assets kept in custody are properly safeguarded and that the third party complies at all times with its contractual terms.

In addition, the Depository must have the right to request and obtain information in relation to accounts and information in relation to the assets held under custody to enable the Depository to fulfil its oversight and due diligence obligations and in particular allow the Depository to:

- a) identify all entities within the custody the custody chain;
- b) verify that the quantity of the identified financial instruments recorded in the financial accounts of the Depository of the fund matches the quantity of the financial instruments held in custody by the third party;
- c) verify that the quantity of the identified financial instruments recorded and held in a financial instruments account opened at the issuer's Central Securities Depository (CSD), matches the quantity of the identified financial instruments recorded in the financial instruments' accounts opened in the Depository books; and
- d) details of equivalent rights and obligations should the third party further delegate the custody functions to another party.

### Asset Segregation

Where safekeeping functions have been delegated wholly or partly to a third party the Depository shall ensure that the third party (in brief):

- a) correctly records all identified financial instruments in the financial instruments account which is opened in the third party's books;
- b) keep all necessary records and financial instruments accounts;
- c) maintains records and financial securities accounts in a way that ensures their accuracy;
- d) provides the Depository with a statement on a regular basis;
- e) conducts reconciliations, as often as necessary, between its financial instruments' accounts and internal records;
- f) introduces adequate organisational arrangements to minimize the risk of loss or diminution of financial instruments; and
- g) holds the fund cash in an account or accounts with a central bank of a third country or a credit institution authorised in a third country provided that the prudential, supervisory and regulatory requirements apply based on the equivalence principle.

### Third Country Delegate

In case where the safekeeping is delegated to non-EU third parties, Depositaries must seek and obtain a legal opinion from an independent natural or legal person confirming that the applicable insolvency law recognises the segregation of the assets of the Depository's clients from the third party's own assets, from the assets of the third party's other clients and from the assets held by the third party for the Depository own account and that the assets of the Depository clients do not form part of the third party's property in case of insolvency and thus such assets will not be distributed in case of insolvency proceedings for the benefit of creditors.