



December 2014

## ESMA issues technical advice to the EU Commission on (i) insolvency protection when delegating safekeeping functions and (ii) depositary independence

### **Background**

As you will be aware from previous client updates ([April 2014](#) and [August 2014](#)), Directive 2014/91/EU (“**UCITS V**”) came into effect on 17 September 2014 and EU member states are required to transpose UCITS V into their national laws by 18 March 2016. The principal aim of UCITS V is to increase the level of protection enjoyed by UCITS investors. It seeks to do so by introducing new requirements in relation to remuneration, regulatory sanctions and depositaries. The new requirements in relation to depositaries are largely similar to those introduced under the Alternative Investment Fund Managers Directive (Directive 2011/61/EU – “**AIFMD**”) and cover a broad range of requirements including those concerning eligibility, duties, delegation and liability.

UCITS V provides that the EU Commission may issue delegated legislation (level 2 legislation) in order to address certain of its provisions in a more detailed manner. The areas in which the EU Commission may issue such delegated legislation include two areas which were not covered under AIFMD namely:

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- (i) Insolvency Protection - the requirement that a third party to whom safekeeping functions (i.e. the custody of financial instruments or verification of ownership of other assets) have been delegated, take all necessary steps to ensure that in the event of its insolvency, assets held by it for a UCITS are not available for the benefit of its creditors; and
- (ii) Independence Requirement - the requirement for the UCITS management company and depository to act independently of each other.

The EU Commission requested the European Securities and Markets Authority (“ESMA”) to provide it with technical advice upon possible implementation measures which could be introduced by means of level 2 legislation in respect of these two UCITS V requirements. On 26 September 2014 (shortly after UCITS V came into effect), ESMA issued a consultation paper containing draft proposals for such measures and sought feedback on these proposals. This consultation process ended on 24 October 2014. On 28 November 2014 ESMA issued its final technical advice to the EU Commission. We have outlined below the principal aspects of the proposals contained in ESMA’s technical advice.

#### **Technical Advice on Insolvency Protection**

UCITS V provides that the third party to which custody of UCITS assets has been delegated is required to take all necessary steps to ensure that in the event of insolvency of the third party, assets of a UCITS held in custody by it are unavailable to its creditors.

ESMA’s technical advice sets out the necessary steps in the form of a non-exhaustive list of the measures, arrangements and tasks that the third party to which custody is delegated should put in place and perform on an on-going basis in order to ensure that the assets of such UCITS are adequately protected. These include the following procedures:

1. In order to ensure that in the event of its insolvency, the assets of a UCITS which a delegate of the depository holds in custody are unavailable for the benefit of its creditors, such *third party* to whom safekeeping has been delegated should, as a minimum, take the following steps:
  - (a) Where the applicable insolvency laws relate to a country outside the EU in which the third party operates:
    - (i) It should make all reasonable efforts (including receipt of appropriate legal advice) to verify that the applicable insolvency laws:
      -  recognise the segregation of assets of the UCITS from its own assets and from the assets of the depository; and

- ◻ recognise that the UCITS segregated assets do not form part of its estate and are unavailable for the benefit of its creditors.
    - (ii) Ensure that the requirements of the applicable insolvency laws to meet the above segregation requirements are met at the time of its appointment and on an on-going basis.
    - (iii) Immediately inform the depositary if it no longer adheres to the requirement at 1(a)(ii) above.
  - (b) Where the applicable insolvency laws relate to the country (whether within or outside the EU) in which the third party operates:
    - (i) Inform the depositary about the applicable insolvency laws and the relevant conditions which apply.
    - (ii) Maintain accurate and up-to-date records and accounts of UCITS asset that readily establish the precise nature, amount, location and ownership status of those assets.
    - (iii) Provide a statement to each depositary on a regular basis detailing the assets of the UCITS are held for and on behalf of such depositary.
    - (iv) Maintain appropriate arrangement to safeguard the rights of the UCITS to its assets and minimise the risk of loss and misuse.
2. The depositary delegating the safekeeping functions to a third party shall adopt the following measures:
- (a) In all cases consider the following matters when selecting and appointing such third party:
    - (i) The legal requirements or market practices related to the holding of client assets that could adversely affect rights of the UCITS during both business as usual and in the event of insolvency of the third party.
    - (ii) The financial condition, expertise and market reputation of the third party.
    - (iii) The protection (or lack of protection) afforded by the regulatory status of the third party.

- (b) In the event that the third party is located outside the EU, the depositary shall:
- (i) Make all reasonable efforts (including receipt of appropriate legal advice) to understand the material effects of the contractual provisions governing the arrangements with the third party on the rights of the UCITS in respect of its assets (including how they would operate in the jurisdictions where the assets are held and in the event of the insolvency of the third party).
  - (ii) Ensure that the contract with the third party contains a provision allowing its termination without undue delay (taking into account the need to act in the best interest of the UCITS and its investors) should the applicable insolvency laws cease to recognise the segregation of the assets of the UCITS, in the event that the third party were to become insolvent or the conditions of the applicable laws are no longer fulfilled.
  - (iii) Where the depositary becomes aware that the applicable insolvency laws no longer recognise the segregation of the assets of the UCITS as outlined in point 2(b)(ii) above, the depositary shall immediately notify the UCITS (or its manager) of this situation. The UCITS (or its manager) shall in turn immediately notify its regulator and consider all appropriate actions in relation to the affected assets (including their disposal taking into account the need to act in the best interest of the UCITS and its investors).
3. In the event that the delegate makes the legal advice which it receives (referred to in point 1(a)(i) above) available to the depositary, the depositary may rely on this advice for the purpose of meeting its requirement as set out in point 2(b)(i).
4. If the depositary obtains legal advice (as referred to in point 2(b)(i) above) and shares it with the third party delegate, the third party may rely upon that advice (provided the advice is sufficiently broad to cover all the matters referred to in point 1(a)(i) above) rather than obtaining further legal advice.
5. In the event that the third party sub-delegates the safekeeping functions, it shall ensure that contractual arrangements are put in place to meet the requirements referred to in points 1-3 above.

#### **Technical Advice on Depositary Independence Requirements**

In accordance with UCITS V, no company may act as both UCITS management company and depositary. Further, a depositary shall not carry out activities with regard to the UCITS management company which may create conflicts of interest between the UCITS, the investors in the UCITS, the UCITS management company and the depositary itself, unless the depositary has functional and hierarchically separated the performance of its depositary tasks from its

other conflicting tasks and the potential conflicts of interest are properly identified, managed, monitored and disclosed to investors.

ESMA's technical advice outlines certain minimum requirements in relation to structures and operational procedures which it proposes should be adhered to in order to enable the depositary and UCITS management company to be deemed to be acting independently of each other. These minimum requirements include:

1. Prohibition on Common Management

- (a) No member of the management body (i.e. board of directors, the "**Board**") of the UCITS management company shall be a member of the Board of the depositary.
- (b) No member of the Board of the UCITS management company shall be an employee of the depositary.
- (c) No member of the Board of the depositary shall be an employee of the UCITS management company.
- (d) Where the Board of either the UCITS management company or depositary respectively, is not in charge of the supervisory functions, no more than one third of the members of the management company or depositary respectively, shall be a member of the Board, the body in charge of the supervisory functions or an employee of the depositary or the management company respectively.

2. Controls Required in respect of Cross Shareholding

- (a) In the event of a cross shareholding between a UCITS management company and the depositary, the management company shall put in place a robust decision making-process for choosing the depositary. This should be based upon objective pre-defined criteria and meet the sole interest of the UCITS and its investors.
- (b) ESMA's proposal to prohibit cross-shareholdings of 10% or more between the UCITS management company and the depositary does not appear in its technical advice. Instead, recognising the disproportionate costs associated with such a proposal, the advice proposes that certain minimum measures must be put in place where one of the entities has (direct or indirect) interest in the other, (i) representing 10% or more of the capital or (ii) representing 10% or more of the voting rights or (iii) which makes it possible to exercise a significant influence over the management of the other entity; or if the UCITS management company and the depositary are included in the same group for the purposes of consolidated accounts. These safeguards include:

- Ensuring that all reasonable steps are taken to avoid conflicts of interest arising from the shareholding or group structure. Where such conflicts of interest cannot be avoided, they are required to be identified, managed and monitored, and where applicable, such conflicts must be disclosed in order to prevent the interests of the UCITS and its investors being adversely affected.
  - The UCITS management company confirming to its regulator that it is satisfied that the decision to appoint the depositary is in the sole interests of the UCITS and its investors.
  - Disclosing to investors the link between the UCITS management company and the depositary; and
  - Provide justification (upon request) to the investors of the choice of depositary.
- (c) In addition, to the requirements set out at point 2(b) above, ESMA technical advice proposes that where the UCITS management company and the connected depositary are included in the same group for the purposes of consolidated accounts, at a minimum the following additional arrangements must be put in place:
- At least one-third or two (persons) of the members of Board (whichever is the lesser) of the UCITS management company and the depositary must be *independent*.
  - At least one third or two (persons) of the supervisory functions (whichever is the lesser) must be *independent* where the members of Board of the UCITS management company and the depositary are not charge of the supervisory function.

ESMA's technical advice sets out what is meant by '*independent*' for this purpose, as individuals who are not; (i) members of the Board, or (ii) members of the body in charge of the supervisory function, or (iii) employees of any of the other undertakings within the group and who are free of any business, family or other relationship with the UCITS management company, the depositary and any other undertakings within the group that creates a conflict as may impair their judgement.

## Next steps

ESMA will assist the EU Commission to prepare level 2 legislation based upon its technical advice. It is currently anticipated that the formal level 2 legislation will be in place by next July at the latest. EU member states must adopt and publish the laws and regulations necessary to comply with UCITS V by 18 March 2016.

## December 2014

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