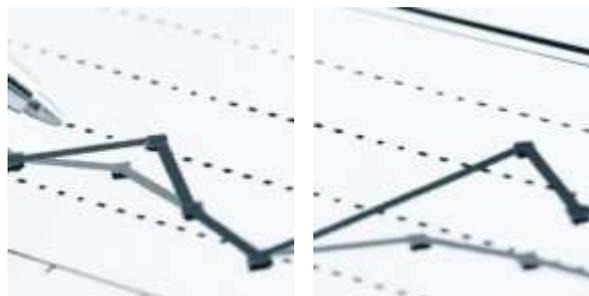


Newsletter Luxembourg

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Investment Funds

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■ The new depositary regime under the Luxembourg law of 10 May 2016

The new law implementing the so-called “UCITS V Directive” (i.e. the European directive 2014/91/UE of 23 July 2014) was adopted on 10 May 2016 (the “Law”) and published in the [Mémorial A n°88](#).

The Law introduces new rules regarding the functions of the depositary of an undertaking for collective investment in transferable securities (“UCITS”), clarifies the manager remuneration and harmonises the sanctions regime, and amendments relating to access to telephone and data records. The Law amends the law of 17 December 2010 relating to undertakings for collective investment (the “2010 Law”) and the law of 12 July 2013 relating to alternative investment fund managers.

This newsletter only addresses the new features of the Law pertaining to the new rules applicable to the UCITS depositary.

Background

The main purpose of the Law is to improve UCITS investors’ protection whose weaknesses have been put forward in both the Madoff and the Lehman Brothers cases where the depositary lost the entrusted assets. Both cases have demonstrated the limits of the disparate implementation of the previous European UCITS directive 2009/65/EC amongst European Member States and the discrepancies of the duties and the liability regime of the depositary. It was time that a new regulation tightened up the rules governing the safekeeping of assets and remedied the investor protection.

Alignment between different types of undertakings for collective investment

The Law aligns the functions and the liability regime of the UCITS depositary regardless of the legal form of the investment fund concerned, be it organised in the corporate form (SICAV or SICAF) or as a contractual form (FCP). The Law also aligns the depositary regime of undertakings for collective investment subject to Part II of the 2010 Law with the one of the depositary pertaining to Part I of the 2010 Law.

Eligibility of the depositary

The UCITS V Directive imposes that the depositary function be entrusted to a national central bank, a credit institution or another agreed entity. Under Luxembourg law, the depositary functions may only be entrusted to credit institutions governed by the law of 5 April 2013 relating to the financial sector.

The depositary agreement

The Law expressly requires that the depositary’s duties and liabilities be stipulated in an agreement in writing. The Law further prohibits any possibilities to contractually exclude or

restrain the depositary's liability. Any contractual agreement contrary to this prohibition shall be null and void.

The new liability regime

The Law takes a strict liability stance by basing the new depositary's liability regime on the fundamental principle that it is liable for the safekeeping of the assets that have been entrusted to it. Two different types of assets must be taken into consideration:

(i) Regarding the assets that can be held in custody (e.g. securities), they must be segregated from the depositary's own assets and be identifiable at all times as belonging to a given UCITS. In the event of loss, the depositary is subject to an obligation of result: in this respect, the Law introduces a new standard of proof that means that, unless the depositary can prove that "*the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary*", it must return the equivalent of an identical type or corresponding amount of the lost financial instruments "*without undue delay*".

(ii) Regarding the assets that cannot be held in custody (e.g. derivative contracts), recordkeeping and ownership verification requirements apply. In order to comply with these requirements, the depositary must put in place internal verification systems in order to be able to identify at any time the ownership of such assets.

Delegation rules

The following new delegation rules are introduced on the level of the depositary in order to secure the delegation mechanism by limiting its recourse:

- Tasks are not delegated with the intention of avoiding the requirements laid down in the Law.
- Delegation must be justified and put in place for objective reasons only.
- Delegation is only admitted for the safekeeping functions of the assets.
- Oversight and cash monitoring functions cannot be delegated.
- The depositary has exercised all due skill care and diligence in the selection and appointment of the third party and continues to do so during periodic reviews and ongoing monitoring.

In parallel, the depositary must ensure that the delegate meets a range of specific conditions. On the level of the delegate, the following elements must be complied with at all times during the performance of the delegated functions:

- adequate and proportionate structures and expertise to the nature and complexity of the assets which have been entrusted;
- for custody tasks, the delegate must be subject to (a) effective prudential regulation, including minimum capital requirements and supervision in the jurisdiction concerned, and (b) an external periodic audit to ensure that the financial instruments are in its possession;
- segregation of the clients of the depositary assets from its own assets and from the assets of the depositary in such a way that they can, at any time, be clearly identified as belonging to clients of a particular depositary;
- all necessary steps are in place to ensure that in the event of its insolvency, the assets of a UCITS held by the delegate in custody are unavailable for distribution among, or realisation for the benefit of its creditors; and

- the delegate must comply with the same conditions imposed on the depositary itself, i.e. its appointment is evidenced by a written contract; it complies with the safekeeping requirements for financial instruments and other assets (as above); it is under the same obligations as the depositary not to reuse the assets held in custody for its own account; and it must be independent of the management company.

In terms of liability, the depositary does not have the ability to discharge itself from its liability by reasons of delegation and it remains fully liable for the duties it has delegated.

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