



Council of the
European Union

031141/EU XXVI. GP
Eingelangt am 17/07/18

Brussels, 16 July 2018
(OR. en)

11205/18

EF 211
ECOFIN 745
DELECT 124

COVER NOTE

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	13 July 2018
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union

No. Cion doc.:	C(2018) 4379 final
Subject:	COMMISSION DELEGATED REGULATION (EU) .../... of 12.7.2018 amending Delegated Regulation (EU) 2016/438 as regards safe-keeping duties of depositaries

Delegations will find attached document C(2018) 4379 final.

Encl.: C(2018) 4379 final



Brussels, 12.7.2018
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COMMISSION DELEGATED REGULATION (EU) .../...

of 12.7.2018

**amending Delegated Regulation (EU) 2016/438 as regards safe-keeping duties of
depositories**

(Text with EEA relevance)

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE DELEGATED ACT

Reasons for and objectives of the proposal

Commission Delegated Regulation (EU) 2016/438¹, which supplements Directive 2009/65/EC² as amended by Directive 2014/91/EU³, further specifies depositaries' duties with regard to safe-keeping of UCITS clients' assets. Article 22a(3)(c) of Directive 2009/65/EC requires that where a depositary delegates safe-keeping functions to third parties (custodians), the assets also need to be segregated at the level of the delegate. Article 16 of Regulation (EU) 2016/438 details how this obligation should be fulfilled. Experience gained since 13 October 2016 has shown that further clarification is needed on the requirements laid down in Article 22a(3)(c) of Directive 2009/65/EC.

The European Commission acknowledges that securities and insolvency laws are not harmonised at European level. However, it is imperative to have common rules to ensure protection of assets safe-kept by depositaries or custodians for their clients. This should lead to the clear identification of assets belonging to a particular UCITS and to the protection of such assets in the case of insolvency of the depositary or the custodian. The dedicated provisions of Directive 2009/65/EC and Regulation (EU) 2016/438 pursue these objectives. However, diverging applications by national competent authorities and market participants of the obligations for depositaries as regards safe-keeping of UCITS clients' assets risk undermining the objectives pursued by the above-mentioned EU legal acts. The Commission is therefore proposing amendments to Regulation (EU) 2016/438 to clarify these rules in order to facilitate their uniform interpretation.

This proposal follows-up on the opinion of the European Securities and Markets Authority (ESMA) on asset segregation⁴. ESMA identified 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 proposes that the asset segregation requirements be better defined and complemented by additional safeguards, in particular the requirement to contractually ensure a sufficient flow of information between the depositary and the custodian or sub-custodian. It also suggests strengthening the requirement to maintain accurate record-keeping and reconciliation systems, including calibrating the frequency of reconciliations with respect to the frequency of trading activities relating to all the assets that might be kept in an omnibus account.

Consistency with existing policy provisions in the policy area

This proposal supplements Directive 2009/65/EC amended by Directive 2014/91/EU. It modifies Delegated Regulation (EU) 2016/438. Article 16 of this Regulation has been interpreted by some as requiring separate accounts per depositary and per type of fund to be

¹ Commission Delegated Regulation (EU) 2016/438 of 17 December 2015 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries, OJ L 78, 24.03.2016, p. 11.

² Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302, 17.11.2009, p. 32.

³ Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions, OJ L 257, 28.08.2014, p. 186.

⁴ Opinion of ESMA, 20.07.2017, 34-45-277.

created at each level of the custody chain. However, this proposal aims to clarify that UCITS, AIFs and other client assets can be commingled at the level of the first custodian under the condition that they are initially held by the same depository (or are initially held by the same custodian where the latter further delegates the custody of assets down the custody chain).

The Commission considers that (i) sufficient experience has been gained since 13 October 2016 to conclude that the obligations for depositaries laid down in Article 22a(3)(c) of Directive 2009/65/EC need to be clarified further; (ii) ESMA's opinion reflects a thorough technical assessment of the rules on safe-keeping function; and (iii) there is an urgent need to provide more clarity on the rules on asset segregation to ensure their uniform application throughout the EU.

2. CONSULTATIONS PRIOR TO THE ADOPTION OF THE ACT

Before developing its opinion, ESMA consulted the public twice: from 1 December 2014 to 30 January 2015, and from 21 June - 23 September 2016. ESMA received 38 and 44 position papers in response to the first and second consultation documents respectively, thereby gathering the detailed positions of various stakeholders on the subject. The Commission has based its work on ESMA's opinion of 20 July 2017 and therefore the Commission did not conduct another public consultation prior to drafting this proposal. The Commission launched open public consultation from 29 May to 26 June 2018 and this proposal incorporates the recurring request from the industry to defer the starting date for the application to eighteen months. In addition, the Commission took into account the comments that improved the overall clarity of the legal text.

3. LEGAL ELEMENTS OF THE DELEGATED ACT

The proposal covers the following amendments to Delegated Regulation (EU) 2016/438:

Article 13(1)(c) is amended to provide for the factors that should determine the frequency of reconciliation between the depository's financial securities accounts and internal records and those of the third parties to which safe-keeping functions have been delegated. The trading frequency of the depository's UCITS client and also the trades carried out by other clients, whose assets are held in the same omnibus account, must be taken into account.

Article 13(2) is amended to require that the depository maintains a record in its financial instruments account opened in the name of a UCITS client or in the name of the management company acting on behalf of the UCITS, showing that the assets kept in custody by a third party belong to a particular UCITS client. The depository must at all times have a complete overview of the assets of its UCITS clients where the custody of assets has been delegated to a third party.

Article 15 is accompanied by paragraph 2a to prescribe the minimum details that should feature in the contract between a depository and a third party on delegation of custody of assets of the depository's UCITS clients. The depository 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 financial instruments, identified by an ISIN code or equivalent identifier, which are kept in custody by the third party. Should the third party need to delegate the custody function to another third party, the proposed provision requires the delegating third party to contractually secure equivalent rights from that other third party, as itself granted to the depository.

Article 16 is amended to clarify the asset segregation requirements for the third parties (custodians) to which the custody of UCITS assets has been entrusted. A custodian can hold

assets of UCITS and AIF 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 duty of oversight of the entrusted assets, custodians must issue depositaries 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 mirror those set out in the amendment to Article 13(1)(c) of the Delegated Regulation.

Points (d) and (e) of Article 17(2) and paragraph (3) of Article 17 are deleted because it is proposed to incorporate them into Article 16(1) of the Delegated Regulation pertaining 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.

Paragraph (3) of Article 22 is replaced to introduce a correction of an editorial error in Delegated Regulation (EU) 2016/438: instead of referring to documentary evidence referred to in paragraph 1 of Article 22 that provision should refer to documentary evidence referred to in paragraph 2.

COMMISSION DELEGATED REGULATION (EU) .../...

of 12.7.2018

amending Delegated Regulation (EU) 2016/438 as regards safe-keeping duties of depositaries

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)¹, and in particular Article 26b thereof,

Whereas:

- (1) As a result of differing national securities and insolvency laws, which are not harmonised at the Union level, there is a divergence in the level of protection for financial instruments held in custody for Undertakings for Collective Investment in Transferable Securities ('UCITS') clients from insolvency risks. In seeking to ensure strong client asset protection as provided for under Directive 2009/65/EC, while accommodating more robust national law requirements in relation to those non-harmonised areas, it is necessary to clarify the obligations relating to the safe-keeping of assets laid down in the Directive 2009/65/EC.
- (2) Currently, competent authorities and industry apply the asset segregation requirements laid down in Delegated Regulation (EU) 2016/438 differently. While depositaries, which are at the first level in a custody chain, have the obligation to provide an individual account to hold financial instruments for each UCITS client, it is necessary to clarify that where the custody function is delegated to a third party, the latter should be able to hold assets of one depositary's clients, including the assets for UCITS and Alternative Investment Funds ('AIFs'), in an omnibus account. This omnibus account should always exclude the proprietary assets of the depositary and the third party's proprietary assets as well as assets belonging to other clients of the third party. Correspondingly, in cases where custody function is further delegated, the sub-custodian should be able to hold assets of the delegating custodian's clients in an omnibus account. This omnibus account should always exclude the sub-custodian's proprietary assets and proprietary assets of the delegating custodian as well as assets belonging to other clients of the sub-custodian. This is necessary in order to achieve a healthy balance between the market efficiency and investor protection.
- (3) In order to minimise the risk of loss of assets held in omnibus financial instruments accounts provided by third parties, to whom the custody function has been delegated, the frequency of reconciliations between the financial securities accounts and the records of the depositary of a UCITS client and the third party or between the third

¹ OJ L 302, 17.11.2009, p.32.

parties, where the custody function has been delegated further down the custody chain, should ensure a timely transmission of the relevant information to the depositary. Moreover, the frequency of those reconciliations should depend on any movement in that omnibus account, including transactions relating to the assets belonging to other clients of the depositary that are kept in the same omnibus account as the UCITS' assets.

- (4) The depositary should be able to continue to carry out its duties effectively where the custody of assets belonging to its UCITS clients is delegated to a third party. It is therefore necessary to require that the depositary maintains a record in the financial instruments account it has opened in the name of a UCITS or in the name of the management company acting on behalf of the UCITS showing that the assets kept in custody by a third party belong to that particular UCITS.
- (5) To strengthen the depositaries' standing in relation to third parties to whom the custody of assets is delegated, that relationship should be documented by a written delegation contract. That contract should allow the depositary to take all the necessary steps for ensuring that the assets kept in custody are properly safeguarded and the third party complies at all times with the delegation contract and the requirements of Directive 2009/65/EC and Delegated Regulation (EU) 2016/438.² Furthermore, the depositary and the third party should formally agree whether the third party is allowed to further delegate the custody functions. In that instance, the contract between the delegating third party and the third party to whom the custody functions are further delegated should be subject to the rights and obligations which are equivalent to those established between the depositary and the delegating third party.
- (6) In order to enable the depositary to fulfil its functions it is necessary to strengthen depositaries' oversight over third parties, regardless of whether they are located inside or outside the Union. It should be required that depositaries verify whether financial instruments of UCITS are correctly recorded in the books of those third parties. The records kept by third parties should be sufficiently accurate in order to be able to identify the nature, location and ownership of the asset. To facilitate effective fulfilment of the depositaries' duties, third parties should provide them with a statement on any change affecting the assets held in custody for depositaries' UCITS clients.
- (7) In order to improve the clarity and legal certainty of Delegated Regulation (EU) 2016/438, it is necessary to amend certain internal references which are incorrect. Delegated Regulation (EU) 2016/438 should therefore be amended accordingly.
- (8) In order to allow depositaries time to adapt to these new requirements, the date of application should be deferred for eighteen months after publication of this Regulation in the Official Journal of the European Union.
- (9) The measures introduced by this Regulation are in accordance with the opinion of the European Securities and Markets Authority.³
- (10) The measures introduced by this Regulation are in accordance with the opinion of the expert group of the European Securities Committee.
- (11) Delegated Regulation (EU) 2016/438 should therefore be amended accordingly,

² Delegated Regulation (EU) 2016/438 of 17 December 2015 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries, OJ L78, 24.3.2016, p.11-30.

³ Opinion of ESMA, 20.07.2017, 34 45 277.

HAS ADOPTED THIS REGULATION:

Article 1

Delegated Regulation (EU) 2016/438 is amended as follows:

(1) Article 13 is amended as follows:

(a) paragraph 1 is amended as follows:

(i) point (c) is replaced by the following:

‘(c) reconciliations are 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 in accordance with Article 22a of Directive 2009/65/EC.’;

(ii) the following second subparagraph is added:

‘In relation to point (c) of the first subparagraph, the frequency of the reconciliations shall be determined on the basis of the following:

(a) the normal trading activity of the UCITS;

(b) any trade occurring outside the normal trading activity;

(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 UCITS.’;

(b) paragraph 2 is replaced by the following:

‘2. Where a depositary has delegated its safekeeping functions, with regard to assets held in custody, to a third party in accordance with Article 22a of Directive 2009/65/EC, it shall remain subject to the requirements of points (a) to (e) of paragraph 1. The depositary shall also ensure that the third party complies with the requirements of points (b) to (g) of paragraph 1.’;

(2) in Article 15, the following paragraph 2a is inserted:

‘2a A contract by which the depositary appoints a third party to hold assets of that depositary’s UCITS clients in custody, shall contain at least the following provisions:

(a) a guarantee of the depositary's right to information, inspection, and access to the relevant records and financial instruments accounts of the third party holding assets in custody to enable the depositary to fulfil its oversight and due diligence obligations and in particular allow the depositary to:

(i) identify all entities within the custody chain;

(ii) verify that the quantity of the identified financial instruments recorded in the financial instruments accounts opened in the depositary’s books in the name of the UCITS or in the name of the management company acting on behalf of the UCITS matches the quantity of the identified financial instruments held in custody by

the third party for that UCITS as recorded in the financial instruments account opened in the third party's books;

(iii) verify that the quantity of the identified financial instruments, which are registered and held in a financial instruments account opened at the issuer's Central Securities Depository ('CSD') or its agent, in the name of the third party on behalf of its clients, matches the quantity of the identified financial instruments recorded in the financial instruments accounts opened in the depositary's books in the name of each of its UCITS clients or in the name of the management company acting on behalf of the UCITS.

(b) details of equivalent rights and obligations agreed between the third party and another third party, in the event of a further delegation of custody functions.';

(3) in Article 16, paragraph 1 is replaced by the following:

'1. Where safekeeping functions have been delegated wholly or partly to a third party, a depositary shall ensure that the third party to whom safekeeping functions are delegated pursuant to Article 22a of Directive 2009/65/EC acts in accordance with the segregation obligation laid down in point (c) of Article 22a(3) of that Directive by ensuring and verifying that the third party:

(a) correctly records all identified financial instruments in the financial instruments account, which is opened in the third party's books, in order to hold in custody the financial instruments for the depositary's clients, which excludes proprietary financial instruments of the depositary and of the third party and of the third party's other clients, to enable the depositary to match the quantity of the identified financial instruments recorded in the accounts opened in the depositary's books in the name of each of its UCITS clients or in the name of the management company acting on behalf of the UCITS;

(b) keeps all necessary records and financial instruments accounts to enable the depositary at any time and without delay to distinguish assets of the depositary's clients from the third party own assets, assets of the third party's other clients and assets held for the depositary for its own account;

(c) maintains records and financial securities accounts in a way that ensures their accuracy, and in particular their correspondence to the assets kept safe for the depositary's UCITS clients and on the basis of which the depositary can at any time establish the precise nature, location and ownership status of those assets;

(d) provides the depositary with a statement, on a regular basis and whenever a change in circumstances occurs, detailing the assets of the depositary's UCITS clients;

(e) conducts reconciliations, as often as necessary, between its financial instruments accounts and internal records and those of the third party to whom it has delegated custody functions in accordance with point (c) of Article 22a(3) of Directive 2009/65/EC.

The frequency of the reconciliation shall be determined in accordance with Article 13(1);

- (f) introduces adequate organisational arrangements to minimise the risk of loss or diminution of financial instruments or of rights in connection with those financial instruments as a result of misuse of the financial instruments, fraud, poor administration, inadequate record-keeping or negligence;
- (g) holds the UCITS' 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 applied to credit institutions in that third country are considered by the competent authorities of the UCITS home Member States as at least equivalent to those applied in the Union, in accordance with point (c) of Article 22(4) of Directive 2009/65/EC.';

(4) Article 17 is amended as follows:

- (a) In paragraph 2, point (a) is replaced by the following:

receives legal advice from an independent natural or legal person confirming that the applicable insolvency law recognises the segregation of the assets of the depositary'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 depositary's own account and that the assets of the depositary's UCITS clients do not form part of the third party's estate in case of insolvency and are unavailable for distribution among, or realisation for the benefit of, creditors of the third party to whom safekeeping functions have been delegated in accordance with Article 22a of Directive 2009/65/EC.

- (b) In paragraph 2, points (d) and (e) of are deleted;
- (c) Paragraph 3 is deleted.

(5) In Article 22 paragraph 3 is replaced by the following:

The management company or the investment company shall demonstrate to the competent authority of the UCITS home Member State that it is satisfied with the appointment of the depositary and that the appointment is in the sole interest of the UCITS and the investors of the UCITS. The management company or the investment company shall make the documentary evidence referred to in paragraph 2 available to the competent authority of the UCITS home Member State.

Article 2

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

It shall apply from DATE [OP please insert a date of first day of eighteen month after publication].

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 12.7.2018

*For the Commission
The President
Jean-Claude JUNCKER*