



RETAIL INVESTMENT FUNDS: HOW THE TRANSPOSITION OF THE UCITS V DIRECTIVE WILL IMPACT THE UCITS DEPOSITARY REGIME

1. Introduction

Undertakings for Collective Investment in Transferable Securities (**UCITS**) are (mainly) retail investment funds regulated at European Union (**EU**) level. Following the adoption of the first relevant EU (European Economic Community at that time) Directive in 1985, UCITS have established themselves during the course of time, as a reputed retail investment product both within as well as outside the EU. The first UCITS Directive of 1985 (85/611/EEC) has been repealed in 2009 by the so-called UCITS IV Directive (2009/65/EC), whereas amendments had taken place in the meantime, e.g. as to the eligible assets, in which a UCITS may invest. The UCITS IV Directive has been transposed into Cypriot Law by Law 78 of 2012 on Open-Ended Undertakings for Collective Investment as amended (**UCI Law**). As to the current state of things, the UCI Law will have to undergo significant amendments by March 2016. The reason is that an EU Directive amending the UCITS IV Directive, the so-called UCITS V Directive (2014/91/EU), will be entering into effect at that time and will subsequently have to be transposed into Cypriot law by then. Regarding regulation and supervision of UCITS in Cyprus the competent authority therefore, including the imposition of administrative sanctions, is the Cyprus Securities and Exchange Commission (**CySEC**).

The expected amendments to the UCI Law pursuant to the UCITS V Directive can be categorised into:

- Amendments relating to the remuneration policy and procedures of UCITS managers or of self-managed UCITS (as applicable). The aforesaid amendments brought by the UCITS V Directive aim at discouraging poorly designed remuneration structures and at controlling risk-taking behaviour of individuals involved in the UCITS management process;
- Amendments relating to the entity acting as UCITS depositary (**Depositary**), covering eligible entities, relevant tasks as well as delegation and liability issues. The said amendments aim at modernising the relevant framework, which has remained mainly unaffected since 1985 and take into consideration developments that have occurred in the meantime; and
- Amendments relating to the imposition of administrative sanctions by CySEC.

The present briefing is dedicated to the expected amendments relating to the Depositary as these are laid down in the relevant provisions of the UCITS V Directive (**Depositary Provisions**). As to the structure of this briefing, there will be firstly some background information on the role of the Depositary and on the reasons, which motivated the Depositary Provisions. Subsequently, the Depositary Provisions will be presented in detail.

2. The role of the Depositary and the rationale behind the Depositary Provisions

2.1 The role of the Depositary

Unlike the management of UCITS, which (depending on the legal form of the UCITS) can be performed internally, so that no external UCITS manager (**Manager**)¹ needs in such a case to be appointed,

the appointment of a single Depositary is always required². The Depositary must always be an entity different from the Manager (where applicable) and from the UCITS itself. The Depositary is responsible for the safe-keeping of the assets of the UCITS and for the performance of certain oversight tasks. Apart from the performance of the aforesaid tasks, which are mandatory, the Depositary may be also (contractually) entrusted with other tasks, such as the administration of UCITS. The Depositary has to be always Cyprus based regarding UCITS authorised in Cyprus³. As to the various sub-funds of a so-called “Umbrella” UCITS, the same single Depositary has to be appointed.

2.2 The rationale behind the Depositary Provisions

As to the rationale behind the Depositary Provisions, it has to be noted that these were ‘necessary’, in the sense that these constitute the first significant amendment to the legal framework governing the Depositary at EU Law level, since the introduction of UCITS in 1985. Furthermore, the previous legal framework governing the Depositary was based on broad and abstract formulations that gave rise to diverging interpretations across the various EU member states (**MS**); such divergences existed for instance with regard to the scope of the entities being eligible to act as Depositaries, the way in which the mandatory tasks of the Depositary had to be carried out or the extent of the Depositary’s liability, including the latter’s liability in case of delegation. In addition, significant operational and legal developments occurred, which emphasised the need for the adoption of the Depositary Provisions: Firstly, nowadays custody of financial instruments takes place through electronic book-entries of ‘dematerialised’ or ‘immobilised’ (as applicable) securities; secondly, the depositary regime as to non-UCITS investment funds has already been harmonised at EU level through the AIFM Directive (2011/61/EU), so that a level playing field regarding retail investor protection was required. Thirdly, UCITS investments had been exposed to the Madoff fraud⁴, the latter having been the event that triggered the introduction of the non-UCITS depositary provisions in the AIFM Directive.

In terms of content, the Depositary provisions mainly rely on the relevant provisions of the AIFM Directive, with certain deviations therefrom, given the nature of the UCITS target investors as retail.

3. The Depositary Provisions in detail

3.1 Closed-list of eligible Depositaries

Under the UCITS IV Directive, an entity subject to prudential regulation and supervision could be eligible to act as a Depositary, unless a MS restricted the circle of such regulated entities. The Depositary Provisions provide for a ‘closed-list’ of eligible Depositaries consisting of:

- National central banks;
- Credit institutions; and
- Investment firms, which are authorised pursuant to the EU MiFID Directive (2004/39/EC repealed and recast by MiFID II Directive 2014/65/EU whose transposition is pending), while also leaving space for other entities, to which MiFID and CRD IV standards would apply.

¹ The external manager of a Cyprus authorised UCITS has to be either a UCITS management company authorised in accordance with the UCI Law or with the relevant legislation of another EU MS transposing the EU UCITS IV Directive.

² An exemption from the requirement to appoint a Depositary is provided for currently in Cyprus for exchange traded UCITS of corporate form, subject to compliance with section 35 of the UCI Law; however, as the recitals of the UCITS V Directive suggest, no use of the relevant exemption has been made across the EU, so that it is, following March 2016, to be considered as redundant.

³ It is a Paneuropean requirement that a UCITS and its Depositary be based in the same EU MS.

⁴ UCITS were exposed to the consequences of the Madoff fraud as evidenced on the grounds of the case of a Luxembourg UCITS (Lux Alpha SICAV).

As far as Cyprus is concerned, the UCI Law had initially restricted the circle of eligible Depositaries to credit institutions only. Following a recent amendment earlier this year the relevant wording of the UCI Law has been already aligned with that of the Depositary Provisions.

The responsibility for ensuring the appointment of an eligible Depositary is placed on the governing body of the UCITS (unless the UCITS in question has no legal personality), which differs from the approach taken in the AIFM Directive.

3.2 Uniform performance of oversight tasks

Under the UCITS IV Directive the extent of the oversight tasks of the Depositary was dependent on the legal form of the UCITS, with the Depositary of a UCITS of contractual form being responsible for the wider range of oversight tasks. According to the Depositary Provisions, the range of the Depositary's oversight tasks is the same irrespectively of the legal form of the UCITS in question. Furthermore, the Depositary Provisions introduce, in reliance on the relevant provisions of the AIFM Directive, an additional oversight task: The monitoring of the cash flows of the UCITS and ensuring that cash belonging to the UCITS is always booked on segregated accounts.

3.3 Safe-keeping tasks

3.3.1 Division of safe-keeping tasks into custody and ownership verification and record-keeping

As to the safe-keeping tasks of the Depositary, the Depositary Provisions once again rely on the respective provisions of the AIFM Directive and distinguish between 'financial instruments subject to custody' and 'other assets'. Custody as a function is of enhanced significance in the UCITS context, given that UCITS are required to invest predominantly in liquid financial instruments.

The aforesaid distinction is of importance regarding:

- The content of the safe-keeping tasks depending on whether the asset in question qualifies as 'financial instrument subject to custody' or as 'other asset'. The safe-keeping of the former will consist of custody, whereas the safe-keeping of the latter will consist of ownership verification and record-keeping;
- The eligible delegate of custody tasks. Delegation of custody will have to take place to an entity subject to regulation and supervision, in principle, as well as to external periodic audit, the latter aiming at ensuring that the financial instruments, whose custody has been delegated, are in the delegate's possession;
- The protection to be afforded to the UCITS, in case of insolvency of the Depositary and/or of a delegate of safe-keeping tasks: The Depositary Provisions require that EU MS render, within their territory, 'financial instruments subject to custody' creditor-proof without extending such protection to 'other assets' whose safe-keeping has been delegated; and
- The applicable standard of liability (strict or qualified) and the burden of proof associated therewith.

As to the performance of its safe-keeping tasks in general, the Depositary will have to provide the UCITS or the Manager (as applicable) with an up-to-date inventory of all assets entrusted to it for safe-keeping. The Depositary Provisions do not allow the Depositary to use for its own account the assets of the UCITS entrusted to it for safe-keeping; such use is allowed only for the account of the UCITS, provided also that certain conditions are complied with.

3.3.2 Applicable requirements regarding delegation of safe-keeping tasks

The Depositary's oversight tasks, including cash flow monitoring, may not be delegated, so that the Depositary Provisions on delegation refer to the delegation of safe-keeping tasks only. The said provisions rely significantly on those of the AIFM Directive with some deviations therefrom taking place. It has to be noted that in the meantime, the deviation regarding the different treatment of custody of financial instruments entrusted to the operator or provider of a securities settlement system, seems to have been reconciled.

In alignment with the AIFM Directive, the delegation of safe-keeping tasks is subject to requirements as to:

- The delegation process itself;
- The person of the Depositary's delegate, whereas in case of delegation of custody, the additional requirements of the delegate's regulated status, supervision, minimum capital requirements and external periodic audit apply (**'Additional Requirements'**);
- The implementation of operational arrangements, including that of segregation, by the Depositary's delegate, in order to render the assets, whose safe-keeping has been delegated 'creditor-proof', in case of insolvency; and
- Compliance by the Depositary's delegate with the general obligations and prohibitions applying to the Depositary.

The Depositary Provisions introduce an exception for the case where no custody delegate satisfies in a particular jurisdiction the Additional Requirements in terms of regulation, supervision or regulatory capital, while local law requires local assets to be locally held. In this case, delegation of custody will be allowed as in the AIFM Directive, i.e. following relevant disclosure to the UCITS investors and relevant instructions from the Manager or the UCITS (as applicable).

3.3.3 Depositary's liability

In reliance on the relevant provisions of the AIFM Directive, the Depositary's liability will take the form of strict liability for the (definite) loss of 'financial instruments subject to custody' (**'Loss'**) and of qualifying liability for all other losses. Where the former is the case, the burden of proof rests with the Depositary. The Depositary will exempt itself from liability for the Loss only if it manages to prove that the Loss was due to an uncontrollable external event with unavoidable consequences. Otherwise, the Depositary will have to provide equivalent restitution in cash or in kind without undue delay. In case of qualifying liability, the burden of proof rests with the claimant to establish the Depositary's liability.

However, there are also deviations in the Depositary Provisions from the liability concept of the AIFM Directive:

- The Depositary will not be able to discharge itself of liability in case of delegation by transferring it to its delegate or to otherwise limit it. The aforesaid deviation is motivated by the (retail) nature of UCITS investors, who would be otherwise exposed to costly and uncertain legal proceedings against the Depositary's delegate; and
- UCITS investors may under the Depositary Provisions raise direct claims against the Depositary, without such individual right being dependent on the legal form of the UCITS as in the AIFM Directive; provided that such individual action (if taken) does not amount to duplication of redress or to unequal treatment of the investors.

4. Conclusion

While awaiting the 'Level 2' measures, there are some conclusions that can be drawn regarding the Depositary Provisions: Unlike previous legislative initiatives at EU level, which aimed at enhancing the commercialisation of UCITS, e.g. by expanding the scope of eligible assets⁵ or by enabling cross-border UCITS management⁶ or by introducing quasi distribution channels in the UCITS context through the Master-Feeder structures⁷, the Depositary Provisions take a less commercial and a more 'protectionist' approach as evidenced by:

- The creation of a 'closed-list' of eligible Depositaries;
- The range of the Depositary's oversight tasks, which will be the same irrespectively of the legal form of the UCITS, and is also expanded to comprise cash-flow monitoring;
- The introduction of the strict liability regime for 'financial instruments subject to custody' and of qualifying liability for 'other assets' without allowing for the contractual exclusion or limitation thereof, including cases of delegation; and
- The right of UCITS investors to invoke (in principle) the Depositary's liability directly irrespectively of the legal form of the UCITS.

⁵ Through the so-called 'Eligible Assets Directive'.

⁶ The so-called 'management company passport' reinforced by the UCITS IV Directive.

⁷ Once again through the UCITS IV Directive.