

Luxembourg: new CSSF Circular 16/644 on duties of UCITS depositary banks

In October 2016, the Commission de Surveillance du Secteur Financier ('CSSF') issued Circular 16/644, which replaces and repeals Circular 14/587. Addressed to Luxembourg credit institutions acting as depositary of UCITS as well as to all Luxembourg UCITS, including, where applicable, UCITS management companies, it elucidates a number of regulatory requirements which the Law of 17 December 2010 ('Law of 2010') and the Commission Delegated Regulation (EU) 2016/438 ('EU Regulation') have established. In particular, the document clarifies the depositary regime as it introduces new definitions and requirements while confirming most of the rules spelled out in Circular 14/587.

Designation of a credit institution as depositary for UCITS

The procedure and criteria a credit institution needs to satisfy in order to act as a depositary remain essentially unchanged. However, the new circular specifies the information the CSSF requires in order to evaluate the substance of the entity. It is important to note that this assessment on the part of the CSSF focuses on the delegation and operational model that the credit institution intends to adopt. Following the new circular, an additional approval by the CSSF is only needed if the elements of the initial approval have changed fundamentally, for example, in case of modifications in the delegation or operational model.

Elucidation of strategic definitions

The new circular clarifies several strategic definitions. Most notably, it distinguishes between 'delegation' and 'outsourcing' of activities. The term 'delegation' refers to the safekeeping activities assigned to a third party. By contrast, 'outsourcing' involves the complete or partial transfer of operational tasks from the depositary to a third party, which may belong to the same group. Moreover, the document defines the term 'material activity', as opposed to 'non-material activity'. A 'material activity' is an activity that, if incorrectly performed, may reduce the depositary's ability to satisfy regulatory requirements. In addition, the notion includes all activities that are necessary to the depositary's proper risk management. The outsourcing of a material activity requires prior authorisation by the CSSF.

Further guidance regarding the depositary agreement

The new circular offers further guidance on the information the depositary agreement between the parties needs to contain. The agreement needs to be supplemented by a mapping table showing that it covers all the requirements that Article 2.2 of the EU Regulation contains. In addition, it must include a clause designating Luxembourg law as the applicable law. The new circular confirms the possibility to only disclose the main principles of the escalation procedure in the depositary agreement and to set out the procedure's details in a different document signed by the parties of the depositary agreement. It also reaffirms the option to stipulate in the depositary contract the depositary's right to benefit from a general or specific pledge on the assets of the UCITS on deposit. By contrast, the circular modifies specific provisions that apply in case of termination of a depositary agreement. If a depositary agreement is terminated without the appointment of a new depositary before the end of the notice period, particular custody arrangements relating to the assets of the UCITS need to be put in place with due consideration of the interest of the investors and the UCITS must inform the CSSF accordingly. Finally, if a UCITS is set up as an investment company and has selected a management company, the depositary agreement must be a tripartite agreement between the UCITS, the depositary and the management company, in view of facilitating the mandatory exchange of information between the depositary and the management company.

Delegation framework

The new circular defines ‘delegate’ as any third party appointed by the depositary to which the depositary confers its safekeeping duties. This term subsumes the notions ‘sub-custodians’ and ‘third-party custodians’ that had been formerly in use. A UCITS can delegate the asset management function to an entity linked to the depositary by a common management or control under specific conditions. However, contrary to the previously applicable regime, which contained a range of specific norms, the new circular articulates only general delegation rules. What is more, it establishes a general right for the depositary to refuse any third party acting as delegate of safekeeping functions the UCITS has chosen and appointed.

Governance pertaining to the assets of a UCITS

The new circular restates the rules on diligence and segregation as set out in Circular 14/587, confirming in particular the segregation duties of the depositary and its delegates as well as the use of an ‘omnibus account’. However, it no longer contains rules relating to the prime broker. As a consequence, the general rules that the circular, the Law of 2010 and/or the EU Regulation articulate apply in case of the appointment of a prime broker.

Amendment of the Annex 1

The new circular modifies Annex 1, which lists information to be reported to the CSSF, in that it removes the obligation to send both the annual auditor report on the adequacy of the depositary’s organisation and the annual description of the compliance section.

No further guidance on independence and UCI governed by Part II of the Law of 2010

However, disappointingly enough for all relevant stakeholders, the new circular fails to provide additional guidance on independence rules applicable to the management company and the depositary and on the specific depositary regime applicable to Undertakings for Collective Investment (UCIs) governed by Part II of the Law of 2010.