



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

of 12.7.2018

amending Delegated Regulation (EU) No 231/2013 as regards safe-keeping duties of depositaries

(Text with EEA relevance)

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE DELEGATED ACT

Reasons for and objectives of the proposal

Delegated Regulation (EU) No 231/2013¹, which supplements Directive 2011/61/EU² and in particular Section 3, further specifies depositaries' duties with regard to the safe-keeping of AIF clients' assets. Article 21(11)(d)(iii) of Directive 2011/61/EU 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 99 of Delegated Regulation (EU) No 231/2013 details how this obligation shall be fulfilled. Experience gained since 22 July 2013 has shown that further clarifications is needed on the requirements laid down in Article 21(11)(d)(iii) of Directive 2011/61/EU.

The European Commission acknowledges that securities and insolvency laws are not harmonised at EU 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 AIF and to the protection of such assets in the case of insolvency of the depositary or the custodian. The dedicated provisions of Directive 2011/61/EU and Delegated Regulation (EU) No 231/2013 pursue these objectives. However, diverging applications by national competent authorities and market participants of the obligations for depositaries as regards safe-keeping of AIF clients' assets risk undermining the objectives pursued by the above-mentioned EU legal acts. The Commission is therefore proposing amendments to Regulation (EU) No 231/2013 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 segregation³. 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 requirements 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 may be kept in an omnibus account. ESMA further suggests that the due diligence duties of depositaries should be supplemented by requiring them to have a good understanding of the implications that the insolvency laws of a third country could have if safe-keeping is delegated to custodians located outside the EU.

Consistency with existing policy provisions in the policy area

This proposal supplements Directive 2011/61/EU. It modifies Delegated Regulation (EU) No 231/2013. Article 99 of this Regulation has been interpreted by some as requiring separate accounts per depositary and per type of fund to be created at each level of the custody chain.

¹ Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision, OJ L 83, 22.03.2013, p. 1.

² Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, OJ L 174, 1.07.2011, p. 1.

³ Opinion of ESMA, 20.07.2017, 34-45-277.

However, this proposal clarifies that assets of UCITS, AIFs and other clients can be commingled at the level of the first custodian provided 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 22 July 2013 to conclude that the obligations for depositaries laid down in Article 21(11)(d)(iii) of Directive 2011/61/EU need to be clarified further; (ii) ESMA's opinion reflects a thorough technical assessment of the rules on safe-keeping functions; 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

While developing its opinion ESMA consulted the public twice: from 1 December 2014 to 30 January 2015, and from 21 June to 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 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) No 231/2013:

Article 89(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 AIF 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 89(2) is amended to require that the depository maintains a record in its financial instruments account opened in the name of an AIF client or in the name of the AIFM acting on behalf of the AIF showing that the assets kept in custody by a third party belong to a particular AIF client. The depository must at all times have a complete overview of the assets of its AIF clients where the custody of assets has been delegated to a third party.

Article 98 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 AIF 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 another third party, as itself granted to the depository.

Article 99 is amended to clarify the asset segregation requirements for the third parties (custodians) to which the custody of AIFs assets has been entrusted. A custodian can hold assets of UCITS and AIFs 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 the 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 mirrors those set out in the amendment to Article 89(1)(c) of the Delegated Regulation.

Article 99 is also amended to introduce new obligations for depositaries which delegate the custody of assets to third parties located outside the EU. Legal advice from independent parties on the insolvency laws of the third country is required. The depositaries should also ensure that the third party complies with their national laws securing the benefits of asset segregation and that the third party communicates any changes to the insolvency laws which are a part of the legal system in which they are operating.

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THE EUROPEAN COMMISSION,

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

Having regard to Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers¹, and in particular Article 21(17) thereof,

Whereas:

- (1) As a result of differing national securities and insolvency laws, which are not harmonised at Union level, there is a divergence in the level of protection for financial instruments held in custody by third parties for Alternative Investment Funds ('AIFs') clients from insolvency risks. In seeking to ensure strong client asset protection as provided for under Directive 2011/61/EU 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 Directive 2011/61/EU.
- (2) Currently competent authorities and industry apply the asset segregation requirements laid down in Delegated Regulation (EU) No 231/2013 differently. While depositaries, which are at the first level of a custody chain, have the obligation to provide an individual account to hold financial instruments for each AIF 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 AIFs and Undertakings for Collective Investment in Transferable Securities ('UCITS'), 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.

¹ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 1.7.2011, p. 1).

- (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 an AIF client and the third party or between the third 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 AIF's assets.
- (4) The depositary should be able to continue to carry out its duties effectively where the custody of assets belonging to its AIF 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 its AIF client or in the name of the AIFM, acting on behalf of the AIF, showing that the assets kept in custody by a third party belong to that particular AIF.
- (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 ensuring that the assets kept in custody are properly safeguarded and that the third party complies at all times with the delegation contract and the requirements of Directive 2011/61/EU and Delegated Regulation (EU) No 231/2013. 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 arrangement or contract between the delegating third party and the third party to whom the custody functions are further delegated should be subject to 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 the third parties, regardless of whether they are located inside or outside the Union. It should be required that depositaries verify whether financial instruments of AIFs are correctly recorded in the books of a third party and that the records kept are sufficiently accurate in order to be able to identify the nature, location and ownership of the assets held in custody. 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 the depositaries' AIF clients.
- (7) As part of the depositaries' obligations to exercise care and diligence in cases of delegation of the custody functions, before delegating this function to a third party located outside of the Union, the depositary should receive an independent legal opinion assessing the insolvency law of the third country where that third party is located this includes an evaluation of the level of protection afforded by segregated financial instruments accounts in that jurisdiction. The opinion provided for each jurisdiction by relevant industry federations or by law firms for the benefit of several depositaries should be acceptable. Furthermore, the depositary should ensure that the third party located outside the Union informs it of any change in circumstances or in that third country's insolvency law that may affect the status of the assets of the depositary's AIF clients.
- (8) In order to allow depositaries time to adapt to the new requirements contained in this Regulation, the starting date of application of this Regulation should be deferred for eighteen months after publication 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.²
- (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) No 231/2013 should therefore be amended accordingly,
- HAS ADOPTED THIS REGULATION:

Article 1

Delegated Regulation (EU) No 231/2013 is amended as follows:

- (1) Article 89 is amended as follows:
- (a) paragraph 1 is amended as follows:
- (i) point (c) is replaced by the following:
- ‘(c) reconciliations are conducted as often as necessary between the depositary’s internal accounts and records and those of any third party to whom custody functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU.’;
- (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 AIF;
- (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 AIF.’;
- (b) paragraph 2 is replaced by the following:
- ‘2. Where a depositary has delegated its custody functions to a third party in accordance with Article 21(11) of Directive 2011/61/EU, it shall remain subject to the requirements of points (a) to (e) of paragraph 1 of this Article. It shall also ensure that the third party complies with the requirements of points (b) to (g) of paragraph 1 and segregation obligations laid down in Article 99.’;
- (2) in Article 98, the following paragraph 2a is inserted:
- ‘2a. A contract, by which the depositary appoints a third party to hold assets of that depositary’s AIF 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 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:

² Opinion of ESMA, 20.07.2017, 34 45 277.

- (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 AIF or in the name of the AIFM, acting on behalf of the AIF, matches the quantity of the identified financial instruments held in custody by the third party for that AIF 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 AIF clients or in the name of the AIFM acting on behalf of the AIF;
- (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) Article 99 is amended as follows:

(a) 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 safe-keeping functions are delegated pursuant to Article 21(11) of Directive 2011/61/EU, acts in accordance with the segregation obligation laid down in point (iii) of Article 21(11)(d) 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 AIF clients or in the name of the AIFM acting on behalf of the AIF;
 - (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 instruments accounts in a way that ensures their accuracy, and in particular their correspondence to the assets kept safe for the depositary's AIF 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 in any case whenever a change in circumstances occurs, detailing the assets of the depositary's AIF 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 safe-keeping functions in accordance with Article 21(11) of Directive 2011/61/EU.

The frequency of the reconciliation shall be determined in accordance with Article 89(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) where the third party is an entity referred to in points (a), (b) and (c) of Article 18(1) of Directive 2006/73/EC, which is subject to effective prudential regulation and supervision that has the same effect as Union law and is effectively enforced, the depositary shall take the necessary steps to ensure that the AIF's cash is held in an account or accounts in accordance with Article 21(7) of Directive 2011/61/EU.;

(b) the following paragraph 2a is inserted:

‘2a. Where a depositary delegates its custody functions to a third party located in a third country in accordance with Article 21(11) of Directive 2011/61/EU, in addition to the requirements of paragraph 1 of this Article, the depositary shall ensure the following:

- (a) the depositary receives legal advice from an independent natural or legal person confirming that the applicable insolvency law recognises the following:
 - (i) 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;
 - (ii) the assets of the depositary's AIF clients do not form part of the third party's estate in case of insolvency;
 - (iii) the assets of the depositary's AIF clients are unavailable for distribution among, or realisation for the benefit of, creditors of the third party to whom custody functions have been delegated in accordance with Article 21(11) of Directive 2011/61/EU;
- (b) the third party takes the following steps:
 - (i) it ensures that the conditions laid down in point (a) are met when concluding the delegation agreement with the depositary and on an ongoing basis for the entire duration of the delegation;
 - (ii) it immediately informs the depositary whenever any of the conditions referred to in point (i) are no longer met;

(iii) it informs the depositary about any changes to applicable insolvency law and its effective application.?’;

(c) paragraph 3 is replaced by the following:

Paragraphs 1, 2 and 2a shall apply mutatis mutandis when the third party, to whom safe-keeping functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU, has decided to delegate all or part of its safe-keeping functions to another third party pursuant to the third subparagraph of Article 21(11) of Directive 2011/61/EU.

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 - first day of the eighteen months 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