Depositary Bank Compliance Check
Going through the looming challenges

The last financial crisis placed depositaries in the spotlight and none can ignore the dramatic increase of European rules which impact the depositaries activities. AIFMD and UCITS V largely focus on a re-cast in safekeeping liability and oversight duties, while other indirect consequences for the depositary bank stem from EMIR. It’s now the right time to act and reposition within this new environment.

The situation
The ambivalence of the Luxembourg depositary’s roles (as an independent watchdog over the management company/AIFM’s activity, on the one hand, and as its service provider for certain delegated tasks, on the other hand) and the corresponding difficulty to strike the right balance between a fiduciary function enshrined in law and business and operational constraints met in practice, has always represented a challenge to the industry.

The post-crisis regulations, destined to strengthen the monitoring activities of AIF and UCITS’ value chain and to enhance the safety of processes within the industry, have taken this challenge a step further. AIFMD and UCITS V are creating the future regulatory and supervisory framework for non-UCITS and UCITS, respectively. EMIR is further reshaping the OTC derivative market, and designed to reduce counterparty risk and increase collateralisation.

Overall, the conditions of safe-keeping of assets, the due diligence and supervision duties over sub-custodians, if any, and the monitoring of the fund’s operations have significantly increased with these new regulations. Collateral management at depositary’s level has been overhauled.

So it is crucial for depositaries to assess early the gap, if any, between their current operations and what they will need to do to face the new obligations. Once full compliance is reached, processes and organisation must be regularly challenged against a constantly changing regulatory framework. Most importantly, depositaries should reflect today on the new service offerings they will put in place for their fund clients.
A comprehensive approach to regulatory tasks and business functions

The new European rules keep reshaping the way in which depositary banks have to fulfill their duties, and go always deeper into their processes and market infrastructure:

- While the classic “custody” function necessary to the operation of any kind of investment vehicle remains relatively untouched by the new regulations, the legal “depositary” functions and the contents of the obligations of safekeeping, overseeing and now cash monitoring take an entirely new depth, as does the handling of a sub-custodian network.

- The safekeeping of funds’ assets will, for UCITS and AIF depositary banks, mean enhanced obligations in terms of how to take financial instruments in segregated custody and how to verify and monitor ownership over certain other assets. The regulations strengthen the conditions for delegating safekeeping functions to sub-custodians or to any other entities/counterparties with which assets are deposited; the quality, selection and monitoring of such entities now become a core duty of the depositary bank, which may incur a liability if any of them defaults.

- The liability regime of the depositary, now harmonised at EU level, goes away from the current “best efforts” basis used as regards the supervision of assets and creates a full liability in case of loss of instruments held in custody, with only few possibilities to discharge itself from it.

These regulatory requirements and guidelines will have to be set into a business context in order to assess the mismatch with the current set-up of the value chain and the potential cost of compliance.

How do we approach the issue?

- Safe-keeping Risk
- Monitoring Risk
- Ownership Risk

The management and supervision of entities where assets are held with a due diligence and a continuous monitoring obligation.

The due diligence on other service providers to the UCITS/AIF and the monitoring of tasks and controls as required by laws and regulations.

The oversight of OTC assets and contracts including the logistical, legal and counterparty related risks.
By using our Depositary Bank Compliance Check approach, you’ll have a quick and accurate diagnostics of your business against the key areas of its new compliance responsibilities. Our diagnostic approach is based on a structured catalogue of approx. 150 specific questions/aspects, encompassing both regulatory tasks and business functions. We’ll perform the analysis through interviews or review of selected documents. We’ll focus on the following issues (illustrative; non-exhaustive list per category):

- Describe Luxembourg regulatory requirements;
- Assessment of impacts on current business;
- Benchmark organisation against requirements.

- Identification of compliance risks;
- Identification of new business opportunities;
- Evaluation of risks and opportunities in executive summary roadmap;
- Definition of recommendations.

- Planning of implementation;
- Assistance to implementation of actions & recommendations;
- Project management assistance;
- Controls report.

* Optional extension of the diagnostic

### Compliance with safekeeping regime

#### Safekeeping
- Are financial and other assets defined and identified?
- Has the Bank written safekeeping procedures?
- Does the account structure ensure segregation of assets?
- Are the controls in the securities settlement value chain compliant with new due diligence requirements?

#### Due Diligence
- How are network banks selected?
- What is the procedural evidence for the due diligence?
- What risk criteria are defined to determine the safekeeping risk?
- How is the safekeeping risk delegated to sub-custodians?
- What are the contractual standards set for sub-custodian agreements?
- How often are due diligence reviews updated?

#### Other assets & collaterals
- Does the bank perform reconciliation of positions not held in custody?
- What is the account opening procedure for assets held with counterparties or registrars?
- What are the procedures relative to collaterals posted and received with CCPs vs. OTC?

### Compliance with oversight regime

#### NAV control
- Does the Bank perform a due diligence on the fund accounting agent?
- How is the review the accounting valuation procedure of the central administration performed?

#### Compliance control
- Does the Bank review the compliance monitoring system of the central administration?
- How is the Bank involved in the detection of breaches and the compensation process according to Circular 02/77?

#### TA & Cash monitoring
- How is the cash flow monitored?
- How is the cash held in custody?
- What reporting does the bank receive in case of escalation issues?

#### Transactions settlement & income control
- Is a counterparty acceptance check performed?
- What is the decision making power of the Bank in this acceptance process?
- How are Prime Brokers reviewed and contracted?

### Evaluation results & recommendations

- Extensive improvement needed
- Improvement needed
= Fulfillment of basic requirements
++ Extensive knowledge: specific improvement
++ Expert: no further improvement required

---

How we can help

We’ve designed a modular business and compliance check-up.
What’s in it for you?

Our diagnostic approach is comprised of (1) a presentation of relevant regulatory requirements in terms of the roles, responsibilities and the liability related to AIFMD/UCITS V and EMIR, (2) an executive summary business risk & opportunity roadmap combining both compliance and business risks, which will highlight the areas where your organisation is already largely compliant with regulation and market standards, new opportunities provided by new regulations, as well as those areas where we have identified weaknesses that threaten the soundness of your future business conduct. Finally, (3) optionally, a summary of recommendations and quick wins for your consideration.

Benefits to your organisation

- Review compliance with regulatory obligations;
- Benchmark the organisation against market practice in/outside Luxembourg;
- Roadmap the organisation identifying loopholes or areas of vulnerability, new opportunities and expedience;
- Identify and create internal awareness on business and compliance risks; and
- Detect new business opportunity to be taken, identifying growth streams.

Why PwC Luxembourg?

PwC Luxembourg (www.pwc.lu) is the largest professional services firm in Luxembourg with 2,300 people employed from 57 different countries. It provides audit, tax and advisory services including management consulting, transaction, financing and regulatory advice to a wide variety of clients from local and middle market entrepreneurs to large multinational companies operating from Luxembourg and the Greater Region. It helps its clients create the value they are looking for by giving comfort to the capital markets and providing advice through an industry focused approach.

Contacts

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Contact Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Olivier Carré</td>
<td>Partner</td>
<td>+352 49 48 44 4147 <a href="mailto:olivier.carre@lu.pwc.com">olivier.carre@lu.pwc.com</a></td>
</tr>
<tr>
<td>Marie-Elisa Roussel</td>
<td>Partner</td>
<td>+352 49 48 48 2050 <a href="mailto:marie-elisa.roussel-alenda@lu.pwc.com">marie-elisa.roussel-alenda@lu.pwc.com</a></td>
</tr>
<tr>
<td>Thierry Blondeau</td>
<td>Partner</td>
<td>+352 49 48 48 2005 <a href="mailto:thierry.blondeau@lu.pwc.com">thierry.blondeau@lu.pwc.com</a></td>
</tr>
<tr>
<td>Lionel Nicolas</td>
<td>Partner</td>
<td>+352 49 48 48 4172 <a href="mailto:lionel.nicolas@lu.pwc.com">lionel.nicolas@lu.pwc.com</a></td>
</tr>
</tbody>
</table>

Please refer to our “The AIFMD strategy - Making your AIFMD strategy pay” flyer for more information (www.pwc.lu/aifmd).