

# *The new CSSF Circular 16/644 applying to depositaries of Luxembourg UCITS*

8 December 2016

## *In brief*

CSSF Circular 16/644 (“the Circular”) came into force on 13 October 2016. It cancels and replaces CSSF Circular 14/587 (the “Old Circular”).

The Circular follows the publication of the UCITS V Directive<sup>1</sup> and the publication on 24 March 2016 of the so-called “level 2 Regulation”<sup>2</sup> by providing further details on the rules applicable to depositaries of UCITS under the new UCITS V regime.

The Old Circular was published on 11 July 2014 and aimed at modernising the 25 year-old Chapter E of Circular 91/75 in anticipation of the new UCITS V framework.

The publication and the subsequent entry into force of the UCITS Regulation on 13 October 2016 made it necessary to revise the Old Circular necessary. This is due to a number of the provisions in the Old Circular becoming redundant and contradictory to the new provisions in the level 2 Regulation.

The Circular provides further clarifications for the level 2 Regulation and imposes certain constraints on depositaries of Luxembourg UCITS, as well as to Luxembourg UCITS and their management companies, that are not specifically covered by the amended UCITS Directive or the level 2 Regulation. The Circular does not apply to UCIs under part II of the law of 17 December 2010 that remain subject to the depositary rules applying to AIFs.

## *In detail*

The main clarifications or novelties in the Circular are explained below.

### **Removal of the reference to prime brokers**

The concept of “prime broker” is removed. The removal indicates the very limited possibility to use prime broker services since neither the UCITS V Directive nor the level 2 Regulation provides for a specific prime broker regime. As such, UCITS funds can use counterparties “qualifying” as prime broker entities, but are not allowed to use the “prime brokerage” services.

<sup>1</sup> Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014  
<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0091>

<sup>2</sup> Commission Delegated Regulation (EU) 2016/438 of 17 December 2015  
[http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L\\_.2016.078.01.0011.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L_.2016.078.01.0011.01.ENG)

<p><b>Delegation vs Outsourcing of tasks by the depositary</b></p>	<p>The Circular distinguishes between the concept of “delegation” and the concept of “outsourcing” of tasks by the depositary.</p> <p>Delegation refers to a situation where the depositary entrusts certain tasks related to safekeeping of the UCITS assets, to a third party.</p> <p>The conditions for delegation of safekeeping duties are covered extensively in the UCITS V Directive and the level 2 Regulation.</p> <p>Outsourcing refers to a situation where the depositary entrusts certain tasks related to oversight and cash monitoring, to a third party. Let’s remind that a delegation of these duties is not permitted in the UCITS V Directive which explains why the Circular creates the concept of “outsourcing” in relation to the use of service providers to support these duties.</p> <p>The question of whether an outsourced activity (as defined in the Circular) would qualify as a delegation under the UCITS V Directive and, hence, would not be permitted, will have to be analysed on a case-by-case basis. The general concept is to distinguish between full function (delegation) and support tasks to a function (outsourcing).</p> <p>The Circular further defines the concept of “outsourcing of material activities” in line with CSSF 12/552, as the outsourcing of tasks which, if not properly executed, may have an impact on the depositary’s ability to meet the regulatory requirements or continue operations. It also includes tasks which are necessary for a sound and prudent risk management of the depositary.</p>
<p><b>CSSF focus on delegation and outsourcing control</b></p>	<p>Point 9 of the Circular provides that any application to the CSSF for authorisation to act as a depositary of UCITS will have to focus on the delegation of safekeeping duties and the outsourcing of oversight and cash monitoring activities, and on how these delegated/outsourced activities will be handled by the Luxembourg depositary.</p> <p>Point 16 of the Circular provides that the prior authorisation of the CSSF is required when the outsourcing of a material activity is intended. A simple notification being sufficient when outsourcing is made to a Luxembourg bank or professional of the financial sector.</p> <p>Annex 1 to the Circular maintains the obligation on the depositary to provide certain information to the CSSF annually, within 6 months following financial year-end of the depositary.</p>
<p><b>Risk management processes and procedures covering delegation and outsourcing of material activities</b></p>	<p>Point 12 provides that any delegation and outsourcing of material activities must be covered by adequate risk management and delegation/outsourcing control processes and procedures and, as appropriate, by the risk management function of the depositary.</p>

<p><b>Rules applicable to the outsourcing of activities by the depositary</b></p>	<p>Point 15 provides that any outsourcing by the depositary to an external provider must be made in compliance with sub-chapter 7.4. of Circular 12/552. Sub-chapter 7.4. contains the list of conditions to be fulfilled, certain of the key conditions being as follows:</p> <ul style="list-style-type: none"> <li>• The depositary’s obligation to effectively monitor outsourced activities;</li> <li>• The access of the CSSF, the external auditor and the internal control functions of the depositary to the information relating to the outsourced activities so that they can issue an opinion on the matter. This access implies that they can also verify the relevant data held by an external partner and, in the cases provided for in national law, have the power to perform on-site inspections on an external partner. The aforementioned opinion may, where appropriate, be based on the reports of the sub-contractor’s external auditor;</li> <li>• The depositary shall take into account the risks associated with the outsourcing “chains” (where a service provider outsources);</li> <li>• The depositary must have an outsourcing policy which considers the impact of outsourcing on the depositary’s business and the risks it faces. It shall include reporting requirements and control mechanism which the depositary implements;</li> <li>• Special attention should be paid to the continuity aspects and the revocable nature of outsourcing. The depositary should be able to continue its daily operation normally in cases of exceptional event or crisis. In this respect, the outsourcing agreements should not include any termination or service termination clause because of reorganisation measures or a winding-up procedure that may apply to the depositary;</li> <li>• The depositary shall also take the necessary measures to be able to adequately transfer the outsourced activities to a different provider or to perform those activities itself whenever the continuity or quality of the service provisions are affected.</li> <li>• For each outsourced activity, the depositary shall designate a person who will be in charge of managing the outsourcing relationship and managing access to confidential data from among its employees.</li> </ul>
<p><b>Law applicable to the depositary agreement</b></p>	<p>The Luxembourg law must be the one applicable to the depositary agreement.</p>

<p><b>Formalisation of relationships of the depositary with “external persons”</b></p>	<p>Points 13, 30 and 33 provide that any delegation or outsourcing must be formalised in an agreement with the depositary.</p> <p>It further requires that any ongoing work relationship that the depositary may have in the context of its duties to the UCITS, with an external person that it has not chosen (*), should also be formally documented in an operating memorandum, service level agreement or other document agreed between the parties.</p> <p>(* ) Such as the UCITS administration or registrar agent.</p> <p>Point 31 provides that the internal audit or internal control department of the depositary must ensure the effective application of these requirements.</p>
<p><b>Segregation of accounts at the level of sub-custodians</b></p>	<p>Point 45 clarifies the segregation rules at the level of sub-custodians; omnibus accounts can be opened by the depositary with its sub-custodians on condition that they separately identify:</p> <p>(i) the assets of clients of the depositary which are under “collective management” (i.e. UCITS, Part II funds, SICARs, SIFs and, we assume, although not clearly said in the circular, other vehicles compliant with the AIFM Directive such as RAIFs);</p> <p>(ii) the assets of other clients of the depositary; and</p> <p>(iii) the own assets of the depositary.</p>
<p><b>Segregation of accounts down the delegation chain (sub-sub-custodian and below)</b></p>	<p>Point 49 clarifies that, down the delegation chain, the segregation rules are less restrictive and follow the “pre-existing” rule of segregation of clients’ assets versus own assets. This situation is likely to evolve as a consultation on the matter is in course at EU level.</p>
<p><b>Categorisation of “liquidities” as part of the “other assets” category</b></p>	<p>The definition section as well as point 51 of the Circular clarify that the liquidities/cash of the UCITS form part of the “other assets” category. The obligations applicable to “other assets”, the maintenance of an up-to-date register in particular, consequently also apply to liquidities. As such, cash remains a fungible asset and is only to be segregated in the accounts of the depositary bank (client accounts) as well as in case of instructed cash deposits with third parties. NOSTRO cash positions as well as settlement related cash accounts remain non-segregated.</p>
<p><b>Escalation procedure</b></p>	<p>Points 60 to 63 envisage that a depositary must have in place processes and procedures for escalating issues identified internally and, as appropriate, externally to the UCITS and its management company and, in the absence of relevant action within a reasonable time period, to the CSSF.</p> <p>These points indicate that escalation procedures must also be implemented by the UCITS and its management company including escalation, as appropriate, to the depositary and the CSSF.</p>

**Administration of the UCITS assets**

Points 79 to 81 clarify that, for both FCPs and SICAVs (under the old regime, this was only formally required for FCPs), the depositary shall fulfil all operations concerning the day-to-day administration of the assets. This means that the depositary must, in particular, collect dividends, interest and securities due, exercise rights over securities and, in general, carry out any other operations concerning the day-to-day administration of securities and liquid assets which belong to the UCITS. Such duties may be contractually delegated to sub-custodians.

***In conclusion***

The above is a summary of the key changes in the Circular, as compared to the Old Circular. It does not cover the points which remain unchanged or those removed as they became redundant with the UCITS V Directive. The Circular is to be read in conjunction with further guidelines or Q&A that ESMA may publish in the future.

***Let's talk***

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