Assets segregation in the delegation of custody services as a measure to ensure investment funds clients´ protection. October 2016.

Directive 2011/61/EU on Alternative Investment Fund Managers (hereinafter, AIFMD), and more recently, **Directive 2014/91/EU (known as UCITS V Directive)** which amends Directive 2009/65/EC on Undertakings for Collective Investment in Transferable Securities (UCITS), and regulates depositary tasks, remuneration policies and sanctions contain the depositary provisions on assets segregation. These provisions state that assets belonging to investment funds should be held in custody in separate financial instrument accounts opened in the depository in the name of each Alternative Investment Fund (AIF) or Undertaking for Collective Investment in Transferable Securities (hereinafter, UCITS).

Conversely, under the current regulation the depositary may delegate the functions of assets safe-keeping to third parties *(first level)*, and these third parties in another third party *(second level)* subject to certain requirements such as that the third party shall segregates the assets of the depositary´s clients from its own assets and from the assets of the depositary in such a way that they can at any time be clearly identified as belonging to clients of a particular depositary. Delegating or sub-delegating tasks will not affect the depositary´s duties. Furthermore, the UCITS V Directive, provides which are the depositary´s duties regarding UCITS´s Asset Custody in case of insolvency when safe-keeping tasks are delegated.

ESMA is working on a relevant issue: finding the specific way of complying with the segregation duties -duties of safe-keeping clients´ funds in the custody chain-, i.e., when the depositary delegates the assets´ safe-keeping duties to a third delegated sub-depositary, and when the latter, also does this by delegating them to another sub-delegate.

ESMA issued a report, by the end of 2014, **Consultation Paper. Guidelines on asset segregation under the AIFMD**, with the objective of publishing guidelines related to the asset segregation requirements needed when the AIF depositary had delegated safe-keeping duties of a third party´s assets. AIFMD, *Consideration 40* provides for the following case of delegation of the safe-keeping duties to a third party: *A third party to whom the safe-keeping of assets is delegated should be able to maintain a common segregated account for multiple AIFs, a so-called "omnibus account".*

ESMA understands this account could only comprise AIF assets which safe-keeping has been delegated to a third party and other AIF assets, albeit, not assets of other Collective Investment Schemes (hereinafter, CIS). Nevertheless, some doubts were expounded, as whether assets registered in such account were only those of the same depositary, or if, on the contrary, the account could register AIF assets belonging to other different depositaries which had delegated the safe-keeping all of them to such third party. ESMA proposed two alternative solutions: 1) the account can only register assets of such AIF, and of another AIF of the same depositary who has delegated to the third party, so the AIF assets of other depositaries shall be considered as "other clients´" assets; and option 2) the account can register assets of other AIF of the same depositary and that of a different depositary who has delegated to the third party. Most of the responses received refused both of ESMA´s options, and mainly, stated their preference for one of the five options of the cost-benefit analysis included in the Consultation Paper.

The **publication of the UCITS V Directive** boosted this issue by introducing, as we have seen, asset segregation requirements for UCITS aligned with the AIFM Directive, hence turning the asset segregation regime in a horizontal issue relevant to all types of funds, AIF and UCITS. *Consideration 22* of the referred Directive, explicitly refers to the term "omnibus" account saying that a third party to which the safekeeping of assets is delegated should be able to maintain and omnibus account, as a common segregated account for multiple UCITS.

Given the rejection of the Consultation Paper on the AIFM Directive, and the publication of the UCITS V Directive, ESMA recently published a **Call for Evidence for the investment financial industry (AIF and UCITS) on**

asset segregation and custody services -regarding delegating safe-keeping assets to third parties. ESMA´s objective is for the segregated regime to comply with a double objective: 1) assets shall be clearly identified as belonging to the AIF/UCITS, and 2) investors shall receive appropriate and sound protection, so as to avoid assets´ ownership being questioned where insolvency cases may occur in any such entity of the custody chain.

Thereby, ESMA is eager to get to know the industry´s opinion on different current asset segregation models -including the use of omnibus accounts and that of accounts with different levels-, i.e., what will investor´s protection be in insolvency cases, and which is the most appropriate regime to ensure a high level of investor protection without incurring in great costs or unnecessary requirements. To this effect, ESMA will recuperate those five options of the cost-benefit analysis included in the referred Consultation Paper:

- *Option 1:* The third party delegated sub-depositary (and, in the event a sub-delegated were designated) shall have, on the one hand, separate accounts for the AIF and UCITS assets, and on the other hand, another account for "other clients´" assets ("other assets"); and, shall have separate accounts for the AIF and UCITS assets belonging to each depositary.

- *Option 2:* The third party delegated sub-depositary (and, in the event a sub-delegated were designated), shall have, on the one hand, separate accounts for the AIF and UCITS assets, and on the other hand, another account for "other assets", albeit, it would be possible to combine in one sole account AIF and UCITS assets belonging to different depositaries.

- *Option 3*: The third party delegated sub-depositary (and, in the event a sub-delegated were designated), may have a sole account for the AIF and UCITS assets and "other assets" of the same depositary, but they cannot include in such account assets belonging to different depositaries.

- *Option 4*: The third party delegated sub-depositary may have a sole account for AIF and UCITS assets, "other assets" belonging to the same depositary and assets belonging to different depositaries. In the event a sub-delegated were designated, such may also have in one sole account, assets belonging to clients of the third party delegated sub-depositary, albeit, without being able to include in such account the assets belonging to the depositary or delegated individual.

- *Option 5:* The third party delegated sub-depositary and the sub-delegated shall segregate fund from fund (AIF/ UCITS).

Finally, **Regulation 909/2014, on improving securities settlement in the EU and on central securities depositories** (hereinafter, CSD Regulation), states the CSD shall offer their participants the possibility to choose between segregating in global client accounts and segregating clients individually, when the participant may require it be done in this manner. Likewise, the participant shall offer its clients, at least, the possibility of choosing between both options. ESMA asks about the application of this regime to the investment funds custody chain with which have some similarities. ESMA shall take into account responses received and expects to issue a final report by the end of 2016.

Useful links:

ESMA Call for evidence on asset segregation and custody services (15/7/2016).

ESMA. Consultation paper. Guidelines on asset segregation under the AIFMD (1/12/2014).

Directive 2011/61/EU on Alternative Investment Fund Managers (hereinafter AIFM Directive)

Delegated Regulation 231/2013 supplementing AIFMD with regards to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.

Directive 2014/91/UE (knows as Directive UCITS V) amending Directive 2009/65/CE on Undertaking for Collective Investment in Transferable Securities as regards depositary functions, remuneration policies and sanctions

Delegated Regulation 2016/438 supplementing UCITS Directive with regards to obligations of depositaries

Consultation paper. ESMA´s technical advice to the European Commission on delegated acts required by the

UCITS V Directive (29/9/2014).