

Role of a Depository Bank

dated June 5, 2009

In light of the current market turmoil and the Madoff affair, the CSSF published on May 27, 2009 a press release (“the Press Release”) in connection with the role and responsibility of a UCITS depository bank, and confirmed the general obligation of restitution of assets in custody.

UCITS depository bank responsibility

As a result of the bankruptcy of Lehman Brothers and the Madoff affair, a debate re-emerged between the European Member States and the industry players around the depository bank obligation of restitution of assets in the case where assets are lost due to defaults in the sub-custody network or counterparties of the UCITS.

The Directive relative to Undertakings for Collective Investments in Transferable Securities (“UCITS Directive”) does not fully define the extent of the “safekeeping” role and the related responsibilities of a UCITS depository bank. More generally, the UCITS Directive does not specify whether the safekeeping duty is subject to an obligation of result, or rather to an obligation of means. Such uncertainty results in significant divergences between EU Member States whereby: (i) a minority of Member States have adopted a strict position and regulation: depositaries licensed in these countries are then subject to an obligation of restitution (i.e. obligation of result). This position has been adopted in France where two French depositaries have been recently ordered by the AMF to return securities safekept by their defaulted sub-custodian (i.e. Lehman Brothers)¹. (ii) Other Member States are however more flexible and are of the opinion that depositaries may be discharged of their liabilities in particular in case of adequate monitoring of the sub-custodian network (i.e. obligation of means). An approach which is similar to the US.

Debates at European level

In that context, the European Commission, on January 26, 2009, has decided to review in close collaboration with CESR the implementation of the UCITS Directive in domestic laws, as well as assessing how liabilities of depositaries are defined in each Member State². The exact direction of the upcoming changes in regulation is yet to be seen. In a press release dated May 28, 2009, the Commission announced its intention to strengthen the provisions of UCITS regime, particularly in relation to the UCITS depositaries’ liabilities, in the light of the fraud perpetrated by Bernard Madoff.

Meanwhile, the Commission proposed on April 29, 2009 a new Directive on Alternative Investment Fund Managers Directive (“AIFM Directive”). Although the AIFM Directive is a first draft and subject to changes through the normal European consultation and parliamentary process, it strengthens the depository liability, including an inversion of the burden of proof, and there are clear provisions on delegation as well as on the conditions under which assets can be entrusted to depositaries outside the EU.

Hence, neither the AIFM Directive, nor the so called UCITS IV Directive will alter the role of a UCITS depository bank. The Commission is currently working on a new proposal for UCITS funds.

¹ Paris Court of Appeal (Orders April 8, 2009): The Court decided that French depositaries were subject to obligation of restitution given that they were rendering services of “account holders” and “assets safekeeper” (i.e. “Tenue de compte - conservation”) to their clients. Hence, the legal regime of “Tenue de compte conservation” is applicable to depositaries (Art. 322-4 RGAMF).

² Refer to the Consultation Paper on Proposals for the Review Panel Work Plan (CESR/09-088 - March 2009).

That proposed piece of regulation should at least cover what the AIFM proposal covers in terms of depositary liability to ensure a stringent approach for both retail investors and professional investors. Moreover it should clarify the obligation of result with regards to the restitution of assets, which will largely be ruled by Civil law and legal decisions taken in the coming months or years.

Luxembourg position

The Luxembourg regulator CSSF confirms in its Press Release that depositaries are “safekeepers” and as such must comply with the relevant provisions of the Civil Code and in particular with the legal framework of depositary agreements³. Depositaries are then subject to the general obligation to return the assets in their custody (even in case of failure of its sub-custodians network).

It is noteworthy that such obligation may be however limited by the terms of specific provisions/clauses in the depositary agreement, if considered opposable by the Courts ruling on the investor claims in relation to the UCITS funds impacted by an eventual default or bankruptcy. The exact nature of such “opposable” clauses remains to be seen.

Actions to take

The depositary banks are subject to multiple changes in the markets and infrastructure. On the one hand, the broadening of the business model to include middle-office activities, as well as additional services (e.g. collateral management) and, on the other hand, the future implementation of a harmonised clearing and settlement infrastructure (i.e. Target 2 Securities). The current regulatory initiatives of the European Commission and the confirmation by the CSSF of the depositaries’ obligation of restitution create “new” risks to be considered in the existing business model of most depositaries.

A reassessment of business risks, as well as the review of the internal controls and procedures framework in light of the new regulatory guidance is paramount to ensure regulatory compliance and succeed in the new market environment. The result will be to redefine service level and service catalogue offered to UCI and management companies, as well as the related pricing while considering safekeeping, monitoring and ownership risks. And, driven by a trend of “flight to quality”, the timing of the re-positioning of the depositaries is crucial and ... begins now!

³ Article 1915 of the Civil Code and following.

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