EACB position on the consultation by the Commission Services on the UCITS depositary function and on the UCITS managers' remuneration

31 January 2011

The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4.200 locally operating banks and 63.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 160 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 50 million members and 750.000 employees and have a total average market share of about 20%.

EACB AISBL – Secretariat • Rue de l'Industrie 26-38 • B-1040 Brussels
Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • Enterprise 0896.081.149 • lobbying register 4172526951-19
www.eurocoopbanks.coop • e-mail : secretariat@eurocoopbanks.coop

General remarks

The European Association of Co-operative Banks (EACB) welcomes the Commission's scrutiny of the tasks and obligations of UCITS depositaries. Since the adoption of the UCITS Directive in 1985 the rules relating to depositaries in the directive have remained mostly unchanged. A number of generic principles apply to depositaries, leaving room for diverging interpretations of their duties and related liabilities. This leads to unbalances in the integrated internal market for collective investments and results in drawbacks for certain markets. In this light we welcome a harmonization of the depositary regime.

After the financial crisis and the Madoff-fraud case depositaries moved from barely recognized entities into the spotlight of European legislators. Especially the liability regime of domestic depositaries safekeeping securities in foreign countries has been discussed intensely on a national and European level and played a major role in the debate on the directive on Alternative Investment Fund Managers (AIFM) which includes very detailed obligations for depositaries.

We would like to highlight that it is the investor or the asset manager who decides to invest in collective investments. The depositary has only a controlling function and has no competences on deciding what securities should be purchased. Those decisions are made under the rules in the UCITS directive and under the contractual agreements between the asset manager and the investor. Should an asset manager decide to buy a certain security that needs to be safe-kept in a certain foreign country because of respective national laws, the depositary cannot be made liable for potential frauds of the foreign depositary. The decision on the safe-keeping country was already made with the investment decision of the asset manager. The depositary – not having any decision making power on the investment policy of an asset manager – can only take notice of it. This fundamental pillar of collective investments should be kept also in a revised framework of requirements for depositaries.

In our reply to the set of questions published by the European Commission we would like to focus on the parts concerning the amended obligations for depositaries.

A. Depositary's duties

1. Safe-keeping

Box 1: It is necessary to define what activities and responsibilities are related to the notion of "safe-keeping" of assets.

We fully share the view of the Commission that a clear definition of the activities and responsibilities of depositaries is necessary to the notion of safe-keeping of assets. It should be clarified – especially with respect to "the assets other than financial instruments that can be held in custody" – what the exact contents of the depositary's safe-keeping duties are. It will important to clearly define what a depositary needs to do to comply with the requirements and to verify the ownership of the assets. In addition, a list of assets that are considered as "other than financial assets that can be held in custody" should be provided.

Box 2: It is envisaged to complete articles 22 and 32 of the UCITS Directive, in a way which is consistent with the approach in the AIFM Directive, in order to: Distinguish safekeeping duties between (1) custody duties relating to financial instruments (such as securities) that can be held in custody by the depositary and (2) asset monitoring duties relating to the remaining types of assets. A reference to the custody of physical assets, such as real estate or commodities, is not necessary because such assets are currently not eligible for holding within a UCITS portfolio; Supplement the requirements on custody duties with a segregation requirement, so that any financial instruments on the depositary's book held for a UCITS can be distinguished from the depositary's own assets and at all times be identified as belonging to that UCITS; such a requirement would confer an additional layer of protection for investors should the depositary default; Equip the depositary with a view over all the assets of the UCITS, cash included. The directive should more explicitly make clear that no cash account associated with the funds' transactions can be opened outside of the depositary's acknowledgement, with a view to avoiding the possibility of fraudulent cash transfers; Introduce new implementing measures in the mentioned Articles defining detailed conditions for performing depositary monitoring and custody functions, including (i) the type of financial instruments that shall be included in the scope of the depositary's custody duties; (ii) the conditions under which the depositary may exercise its custody duties over financial instruments registered with a central security depositary; and (iii) the conditions under which the depositary shall monitor financial instruments issued in a nominative form and registered with an issuer or a registrar.

We agree with the idea of the Commission to distinguish the safekeeping duties between custody duties and asset monitoring duties. We also agree with the suggested requirement on custody duties with a segregation requirement, so that any instrument on the depositary's book held for a UCITS can be distinguished from the depositary's own assets. From our perspective the requirements should be flexible enough to allow smooth adjustments in case of changes in investment policies (e.g. the inclusion of investments in real estate) without having to amend the whole directive.

2. Oversight functions

Box 3: It is envisaged to achieve a higher degree of consistency in the oversight duties to be performed by UCITS depositaries: the oversight duties related to UCITS with a corporate form should be aligned with those to be performed in respect to UCITS with a common fund form (article 22).

We welcome the proposed higher degree of consistency in the oversight duties to be performed by depositaries and the alignment of different rules according to the form of organization. From the perspective of an investor there should not be any difference in terms of the level of protection.

Box 4: It is envisaged to introduce implementing measures that will clarify further the scope of each listed supervisory duty, for example the methodology to be used for the calculation of the Net Asset Value of the UCITS.

We agree with the introduction of implementing measures aiming at clarifying the further scope of each listed supervisory duty.

3. Delegation of the depositary's tasks

Box 5: It is envisaged to restrict more explicitly the delegation of the depositary task to the safekeeping duties and that the conditions and requirements upon which a UCITS depositary may entrust its safekeeping duties to a third party should be aligned with those under the AIFM Directive. It is also envisaged to require additional information for UCITS investors be published (for example in the prospectus) where a network of sub-custodians is to be used. Such information would specify the risk that such a sub-depositary network might fail or default, and how this risk can be dealt with. Finally, implementing measures are envisaged in order to detail the depositary's initial and on going due diligence duties, including those that apply to the selection and appointment of a sub-custodian.

According to the proposal of the Commission the delegation of the depositary tasks should be restricted more explicitly to the safe-keeping duties, as already outlined in the AIFMD. From our perspective a delegation should be possible also for other tasks.

B. UCITS depositary liability regime

1. Improper performance

Box 6: It is envisaged that the depositary liability regime might be clarified in case of a UCITS suffering losses as a result of a depositary's negligence or intentional failure to perform its duties.

We consider it as appropriate to harmonise the liability regimes of depositaries. There should not be a competition between different liability rules with diverging severity in the European Union. Different liability rules lead to different costs. The costs of the depositary function should not reflect different regulatory specifics or exemptions, but rather the quality of the services offered in a hugely competitive landscape.

2. UCITS depositary specific liability in case of loss of assets

Box 7: It is envisaged to clarify the UCITS depositary liability regime in case of loss of assets. Accordingly, the UCITS depositary shall be under the obligation to return the financial instruments of the identical type or of the corresponding amount to the UCITS. No further discharge of liability in case of loss of assets is envisaged, except in case of force majeure. Implementing measures should be introduced, as necessary, to clarify all necessary underlying technical aspects, for example to identify the circumstances under which assets may be lost.

3. The scope of the UCITS depositary liability when assets are lost by a sub custodian

Box 8: As already provided under art. 22 and art. 32 of the UCITS directive, it is envisaged to maintain the rule according to which the depositary's liability is not affected if it has entrusted to a third party al or some of its safekeeping tasks. As a result, the depositary faces the same level of liability, should the UCITS assets be lost by a sub-custodian. Moreover, it is envisaged that the legislative proposal should clarify the fact that if assets are lost, the UCITS depositary liability regime has the general obligation to return the financial

instruments of the identical type or of the corresponding amount to the UCITS with no delay. As mentioned above, no further discharge of liability (either regulatory or contractual) in case of loss of assets by a sub custodian shall be envisaged, except in case of "force majeure".

The envisaged UCITS depositary liability regime in case of a loss of assets is too extensive. The depositary cannot guarantee the proper safe-keeping when assets are lost by a sub-custodian. The liability of a depositary should be based on reasonable standards with respect to safe-keeping requirements. Also other parts in the chain – like the asset manager or other third parties – must be taken into consideration. Along the lines of the consultation paper of the Commission depositaries would have to fulfill almost the duties of an insurance. We do not consider this as appropriate. A more acceptable risk allocation would be for the depositary to be in a position to discharge itself of the liability to an investment fund if it can evidence that it took reasonable steps to avoid the loss which has occurred to assets which the depositary safe-keeps.

The proposed strict liability regime would result in a restricted offer by depositaries on some types of assets, because the depositary would not be in a position to assume liability for the sub-custodian and/or would have to increase its fees for the custody services. Without a doubt this would negatively impact the investor access to these types of products that are very much used by retail clients as part of their pension plans.

We would suggest to align the UCITS depositary liability regime with the AIFM directive. According to the AIFM directive a depositary can discharge itself of its liability in case of delegating duties to a third party provided that the depositary stipulates a contract with the third party in which a compensation for investor in case losses is regulated. We would consider such a solution for the UCITS depositary regime as appropriate.

In addition we would like to point out that we do not support the proposal to strictly limit the possibility of discharge to *force majeure* only. This legal concept is not harmonized on a European level and is subject to the definitions provided by national laws or interpretations of the national courts. We are of the opinion that the approach adopted by the European Commission should rather ensure that the liability regime is fully harmonised at the European level in the level 1 text. In this respect we recommend to have a similar approach as the one adopted in the AIFM Directive with the identification of external events which are beyond the reasonable control of the depositary.

4. Burden of the Proof

Box 9: It is envisaged to clarify that the depositary should carry the burden of demonstrating that it has duly performed its duties.

We firmly object the outlines of the Commission on the burden of the proof for depositaries. It is a basic principle that the one making claims should be the one to prove that those are justified. This principle should be also valid in the area of UCITS depositaries. Rules on a less strict burden of proof in certain circumstances on a national level might complement the European obligations. We would like to underline such an amendment would lead to a situation where depositaries will have to carefully consider whether they are in a position to accept those risks and in the end whether to go on with their business. A possible result would be that only a substantially smaller amount of depositaries will exist in the future. We do not think that this would be a desirable result.

5. Rights of UCITS holders action against the UCITS depositary

Box 10: It is suggested to align the rights of UCITS investors, so that both share- and unit-holders are able to invoke claims relating to the liabilities of depositaries, either directly or indirectly (through the management company), depending on the legal nature of the relationship between the depositary, the management company and the unit-holders. Finally, implementing measures should also be introduced in order to encourage a high degree of harmonisation, for example to detail the conditions and procedures under which shareholders may directly use their rights towards a UCITS depositary.

We welcome the proposed alignment of the rights for different groups of UCITS investors enabling them to invoke claims relating to the liabilities of depositaries. Like with respect to the oversight duties also here those rights should not depend on the organizational form of a depositary.

C. Eligibility criteria

1. Eligibility criteria

Box 11: It is suggested to introduce an exhaustive list of entities that should be eligible to act as UCITS depositories, aligned with the AIFM Directive list. Such a list should include: credit institutions, authorised MiFID firms which also provide the ancillary service of safe-keeping and administration of financial instruments, and existing UCITS depositary institutions (by means of a grandfathering clause).

We fully agree with the suggestion to introduce a European list of entities that should be eligible to act as a depositary. There have been many differences across Europe in this respect with a negative impact on those markets that had very strict rules.

2. Location of the depositary (passport issues)

Box 12: It is envisaged that a provision is introduced into the UCITS Directive creating a commitment to assess and re-examine the need to address depositary passport issues, to be undertaken a few years after the new UCITS depositary framework has come into force.

D. Supervision issues

1. Supervision by national regulators

Box 13: Differences between national supervisors' scope of competencies lead to an uneven supervisory framework, suggesting that such competences might be better harmonised. In the Commission's view, this remains a key issue to be addressed in order to fully achieve due levels of harmonisation in practice for the depositary function at the Community level.

2. Supervision by auditors

Box 14: The introduction of a requirement for an annual certification of the assets held in custody by the depositary would clarify the true existence of such

entrusted assets. This annual certification could be performed by the depositary's auditors. Details related to any such requirement might need to be further defined in implementing measures or technical standards as appropriate.

We agree with the Commission proposal to introduce an obligation for an annual certification of the assets held in custody by the depositary's auditors. With such an obligation there would have been no case like Madoff. In this respect, however, it should be clearly stated that the respective costs have to be borne 1:1 by the investment fund.

E. Other issues

1. Derogation from the obligation of UCITS to appoint a depositary

Box 15: It is suggested to delete articles 32 (4) and 32 (5) of the UCITS Directive n°2009/65/EC.

The obligation to have to choose a depositary and the respective deletion of an exemption is fully welcomed by our members. The depositary is a major pillar for ensuring the quality of the UCITS-brand.

2. Single depositary rule

Box 16: It is suggested that the requirement for a single depositary per UCITS should be clarified (without prejudice to Article 113(2) of the UCITS Directive n°2009/65/EC).

The single depositary rule is already in place in many jurisdictions and we would welcome a European harmonization in this respect.

3. Organisational requirements and rules of conduct

Box 17: It is suggested to: Introduce for UCITS depositaries similar rules of conduct as in the AIFM Directive, in addition to the already existing rules stated in the article 22 and 32 of the UCITS Directive; Introduce implementing measures in order to encourage a higher degree of harmonisation and consistency between the organisational requirements applicable to all functions of the UCITS depositary (safekeeping as well as oversight) and, where appropriate, the existing MiFID requirements.

We in principle agree with the proposed rules of conduct for depositaries. We would like to underline that every additional obligation will also lead to an adjustment in the occurring costs that will have to be shouldered by the investor in the end. It is therefore of key importance to carefully assess whether additional requirements are really necessary. It should be avoided that the respective additional costs will make the product less attractive.

4. Exchange of information with competent authorities

Box 18: It is suggested to amend existing requirements concerning the disclose of information to the competent authorities, on their request, in such a way that any information, obtained by a depositary while carrying out its duties, should

be made available to its competent authorities if such information may be necessary for these authorities.

Changes in the existing requirements concerning the disclosure of information to the competent authorities should only be made after an accurate cost-benefit analysis has been carried out. From our perspective the rules outlined in the AIFM directive in this respect would be sufficient enough. Further rules in the UCITS directive are not necessary.

5. The contract between the depositary and the UCITS manager

Box 19: It is suggested that the requirements set out in Article 23(5) and Article 33(5) of the UCITS Directive and their corresponding implementing measures should also apply to a situation where the management company home Member State is also a UCITS home Member State. It appears opportune to require the UCITS depositary to follow conduct of business rules which would oblige a depositary to act honestly, fairly, professionally, independently and in the interest of the UCITS and investors of the UCITS. Furthermore, the depositary should be required to establish appropriate policy for identification, management, monitoring and disclosure of the conflict of interests which may arise when a depositary carries out activities with regard to the UCITS.

We have in principal no objections against a contract between depositary and asset manager also in the case that both are located in the same member state. However, we would like to emphasize that there are certain complexities for contracts in cross-border cases (e.g. two competent authorities involved). This justifies different requirements for domestic and cross-border contracts.

Contact:

The EACB trusts that its comments will be taken into account. For further information or questions on this paper, please contact:

Ms Marieke VAN BERKEL, Head of Consumer Affairs, Payments and Financial Markets
(vanberkel@eurocoopbanks.coop)
Mr Alessandro SCHWARZ, Senior Adviser Financial Markets
(a.schwarz@eurocoopbanks.coop)