

EMEA Centre for Regulatory Strategy

European Commission proposals on a Revision of the Undertakings for Collective Investment in Transferable Securities (UCITS V)



Key changes and impact on firms

The European Commission published on Tuesday 3 July a proposal for regulations and administrative provisions in respect of depositary functions, remuneration policies and sanctions relating to UCITS.

Notwithstanding the impact of the financial crisis on the UCITS industry, this proposal is driven by the fact that the rules relating to depositaries have remained unchanged since the first UCITS Directive was adopted in 1985. In each successive revision there was some discussion in the preliminary stages of a depositary passport and of depositary issues. With UCITS V the European Commission proposes a modernised depositary regime - the challenge will be ensuring that this "modernisation" strikes an appropriate balance.

There are three elements in this proposal:

- A new depositary regime which includes a clarification of the depositaries' duties, responsibilities and liabilities and a set of the rules under which tasks and responsibilities can be delegated – mainly focussing on the sub-custodian network.
- Rules governing remuneration of principal actors (i.e. senior managers, risk takers and those who exercise control functions).
- A sanctions regime.

As one might expect, over the last 25 years, divergences between countries relating to but not limited to liability regimes have emerged. In its impact assessment which accompanied the 2009 consultation document, the Commission highlighted that national divergences in the depositary regime could be the origin of significant legal uncertainty and could lead to different levels of investor protection across the EU. Furthermore, the current UCITS Directive does not contain a single rule to cover conflicts of interest that may arise in the investment fund universe. Whilst the depositary regime has remained unchanged, the third version of the UCITS Directive in 2002 widely enlarged the scope of eligible assets to include more complex UCITS and also UCITS that may be issued and held in custody both inside and outside the EU. Setting up and running a sub-custodian network, which has always been challenging, has become increasingly complex, particularly as there is no harmonized approach among Member States regarding the conditions applicable to this delegation and its ongoing monitoring. It should be noted that these rules have been

included in the Directive on Alternative Investment Fund Managers (AIFMD) which governs alternative investment funds. As such, the existing UCITS regime is lighter than the non-UCITS regime in this area. The UCITS V proposal seeks to rectify the existing discrepancies in rules relating to depositary regimes in the investment funds market, to strengthen consumer protection.

The implementation timeline still needs to be clarified. The proposals published this Tuesday will pass to the European Parliament and to the Council for negotiation and adoption, with requirements not likely to apply until 2 years after they have been adopted and published in the Official Journal. Given the delays already around UCITS V – the proposal was expected in July 2011 - differences between UCITS and AIFMs in the next few years appear inevitable. Unless the Commission can find some way to bridge the gap, retail investors in UCITS will have a lesser depositary regime than investors in Alternative Investment Funds for up to two years before legislation is aligned.

Key changes

This briefing provides an overview of the key changes to the UCITS Directive. We have identified five key changes: 1) Depositaries' duties; 2) Delegation; 3) Eligibility to act as a UCITS custodian; 4) Liability; and 5) Remuneration and sanctions.

1. Depositaries' duties

- The principle of a single depositary is reaffirmed.
- The appointment of a depositary shall be evidenced by a written contract – again a reaffirmation of existing practices rather than an innovation.
- A uniform list of oversight duties that are incumbent on both legal forms of UCITS: contractual UCITS (e.g. Trust / Fonds Commun de Placement) and corporate UCITS (e.g. OIECS, SICAV) – an extension towards a harmonisation of the depositary's role irrespective of the legal structure of the fund. As a consequence, custodian bank responsibilities on corporate UCITS will now include monitoring of investment restrictions and Net Asset Value Calculation whereas it was only the case for contractual UCITS in the past.
- Detailed provisions on cash monitoring. The depositary needs to have a view over all the assets of the UCITS, including cash.
- Introducing a distinction between (1) custody duties relating to financial instruments (such as securities) that can be held in custody and (2) asset monitoring duties relating to the remaining types of assets (such as derivative contracts).

The draft Directive proposes a single depositary regime notwithstanding the legal form of the fund, hence increasing the responsibilities of the depositary bank of corporate UCITS compared to the current regime.

The duties of depositaries are also enlarged in relation to the monitoring of cash and financial assets not held – i.e. assets not held by the depositary itself but a third party appointed by the UCITS such as assets materialised only in a contract such as OTC derivatives. The depositary has now the responsibility to verify the ownership of those assets.

2. Delegation

The proposal aims to align the conditions and requirements upon which a UCITS depositary may entrust its safekeeping duties to a third party with those applicable under AIFMD. UCITS V sets out the conditions under which the depositary's safekeeping duties can be delegated to a sub-custodian. These include the following:

- The depositary can demonstrate that there is an objective reason for the delegation;
- The depositary has exercised all due skill, care and diligence in the selection and the appointment of any third party; and
- The depositary organises periodic review and ongoing monitoring of the third party.

This increases not only the duties of the depositary bank in that area but also affects the policies and procedures UCITS or their Management Company will need to develop.

ESMA, the European Securities and Markets Authority, is expected to give further guidance in implementing

measures on the depositary's initial and on-going due diligence duties, including those that apply to the selection and appointment of a sub-custodian.

3. Eligibility to act as a UCITS custodian

The depositary shall be:

- A Credit Institution; or
- An Investment Firm subject to extensive conditions.

The objective of this provision is to align the regime applicable to investment firms as it was applied differently among some Member States. Generally speaking, this provision will not impact funds actively involved in cross-border activities as the main EU domiciles for UCITS already require the depositary to be a Credit Institution.

4. Liability

- Clarification of the UCITS depositary's liability in case of the loss of a financial instrument that is held in custody. Under the proposals, the UCITS depositary is obliged to return a financial instrument of the identical type or of the corresponding amount to the UCITS if it is deemed liable for the loss. No further discharge of liability in case of loss of assets is envisaged, except if the depositary can prove that the loss is due to an 'external event beyond its reasonable control'.
- Inclusion of the rule by which the depositary's liability is not affected by the fact that it has entrusted to a third party all or some of its custody tasks. As a result, the depositary is obliged to return instruments held in custody that are lost, even if the loss occurred with the sub-custodian.

This proposed rule represents a significant extension of the liability regime and puts it on a par with the higher standards that some Member States have already established in their own national rules. The current UCITS directive is silent as to the responsibility in case of loss of an asset. Moreover, the proposed rule goes beyond AIFMD as the liability cannot be discharged by contract – hence the investor protection expectations are higher in the UCITS universe than in the Alternative Investment one.

In consultation, the industry has consistently pointed out the twin dangers in this approach: investor protection should not mean either the elimination of investor choice, nor should it remove the ultimate responsibility for making an investment decision from the investor. By leaving very few options open, implicitly the proposed Directive may invite the depositary to reject certain markets on the basis that they do not offer sufficient safeguards to allow it to assume its responsibilities in a prudent and satisfactory manner. This not only places the depositary at the heart of the investment process, where most feel it does not belong, but opens up significant other dangers. If a more aggressive depositary is prepared to enter markets that more prudent ones shun, market and failure risk may become more concentrated (i.e. if a single regional custodian is prepared to assume a specific geographic risk, it may become the only viable option for all investments in the region).

Market participants hope that once ESMA's guidance is submitted to the European Commission it will be more widely followed by the Commission than the equivalent AIFMD guidance, much of which was ignored, despite the fact that the compromise reached in the guidance was to the satisfaction of most stakeholders.

5. Remunerations and sanctions

- Introduction of a policy on remuneration of senior management, risk takers and those who exercise control functions.
- Proposition of policies in the financial service sector concerning sanctions – and in particular publication of sanctions and management of authorisations.

In the UCITS universe, similarly to the banking sector, the financial crisis was considered by policymakers to highlight that remuneration policies within firms focused too much on short-term returns, incentivising excessive risk-taking and myopic decision making. The objective of this provision is to ensure that remuneration policies are consistent with sound risk management of the UCITS and do not encourage decisions that are inconsistent with the UCITS's risk profile.

In this respect, the UCITS Directive aligns itself with similar legislation in the Banking sector. The challenge will be articulating recommendations in such a way as to be meaningful, keeping in mind that, unlike AIFMD, the UCITS Directive starts at product level, and product and corporate structures are seldom geometrically aligned.

In May 2011, an ESMA survey revealed that prudential authorities within the EU diverge widely in the criteria and sanctions applied in case of breaches of obligations of the UCITS Directive. The draft Directive proposes a harmonized sanction regime applicable to UCITS. This regime will be developed by ESMA level 2 requirements.

Key impacts on Custodian Banks and Management Companies

- **Custodian bank service offering:**

The increase of duties and responsibilities of custodian banks will impact the service offering and the fee schedule proposed by some organisations, notably for those servicing mainly corporate UCITS and UCITS investing in complex assets. This is likely to drive competition among this segment and lead some custodian banks to focus on more secure markets. The cost increase will be twofold: direct costs linked to increased workload and responsibility, and VAT charges as the supervision duty is subject to VAT, unlike management fees. For small to mid-size funds, this might have a significant impact of their Total Expense Ratios / on-going charges.

- **Management Companies:**

Management Companies will need to re-design their monitoring architecture to take into consideration new duties of depositaries, and in particular the contractual relationship and related reporting between entities. The impact will be even more significant for Management Companies and depositary banks operating in different EU jurisdictions – especially when Management Companies are managing UCITS which are not domiciled in their country via the passport.

Moreover, managers may need to review their existing products if the liability regime or the related cost increases, effectively make investment in some countries non-viable and directly affecting the available choices for the investor.

- **Sub-custody network:**

In order to monitor their responsibilities and mitigate the risk related to the use of a sub-custodian network, depositary banks will need to review their due diligence processes in the appointment of a sub-custodian and monitor them on a regular basis. Once again, the evolution of a market best practice, especially where network management is a centralised group activity based in a competence centre that may not be the same legal entity as the designated depositary, will be the challenge to be faced. The policies and findings will need to be shared with Management Companies.

What's next?

The proposals published this Tuesday will pass to the European Parliament and to the Council for negotiation and adoption. Assuming both sets of negotiations are concluded within 2013, which may be an ambitious timetable, UCITS V could be applicable from 2015 (two years after publication in the Official Journal to allow transposition into national law).

What Custodian Banks can and should be doing now...

While waiting for definitive Level 2 clarification on the detail, there are things that Custodian Banks can and should be doing. Firms can begin addressing the strategic aspects of the proposals and assessing their capabilities, products and processes.

Custodian Banks should assess IT requirements (i.e. the reporting and record keeping aspects); human resource aspects; and the existing and required processes which will need to adapt to this new regulatory framework – especially in the management of sub-custodians and other correspondents. This will inevitably be a lengthy process that will need to be addressed at the early stage of the implementation of this new Directive. Those organisations already AIFMD compliant will be far ahead of their competitors.

Regards

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