

*Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.*

## EBF POSITION ON UCITS V

### Key Points

- The European Banking Federation supports the clarification and harmonisation of UCITS depositaries' tasks and liability across Member States.
- This should be done in far-reaching alignment with the respective requirements under the Alternative Investment Fund Manager Directive (AIFMD). Certainly, the EBF does not believe that there is a case for more stringent requirements than the already very onerous AIFMD rules.
- The EBF favors the creation of one single set of practices for the depositary activities. In this respect, the EBF believes that it would not be appropriate to adopt depositaries' liability rules that go beyond the ones already agreed under the AIFMD.
- The EBF stresses that it is beyond the depositary's capacity to determine in advance of appointing a delegate outside the EU how the insolvency rules in the jurisdiction of such delegate might apply.
- The Federation highlights that the role of the depositary is to ensure that the manager is not breaching the investment limits of the fund on a post-trade basis. Therefore, it should be made clear that as long as a depositary has properly performed its oversight duties, it should not be liable for a breach by the manager that results in a loss in value of assets.

## General remarks

Undertakings for collective investments in transferable securities (UCITS) have proven to be a successful investment product widely used by European and non-European investors. Through several revisions of the first UCITS Directive, new rules have been introduced that further protect investors by, for instance, requiring a new standardized fund document. The European Banking Federation welcomes the Commission's work on UCITS' depositaries to propose further improvement in the legal regime.

This said, since 2011 the EU has introduced a very comprehensive regime for depositary activities under the Alternative Investment Fund Managers Directive (AIFMD). In fact, the Federation considers that the aim of the UCITS V rules regarding the depositary activity should converge to the maximum extent towards the high standards of AIFMD. This convergence would have an important benefit of creating one single set of practices for the depositary activities. The EBF believes that unless the purpose of the UCITS V proposal is to explicitly close some markets to retail investors, it would not be appropriate to adopt depositaries' liability rules that go beyond the ones already agreed under the AIFMD.

The EBF would like to recall that investing in financial markets inexorably and inherently carries a number of risks for investors. These risks should be reduced, controlled and mitigated as much as possible but cannot be totally avoided and therefore the right person at the right level shall be aware of these risks i.e. asset managers, risk managers, the depositaries, supervisors and clients. The relationship between risk and return is a fundamental financial relationship that affects expected rates of return on every asset investment. For that reason, the EBF believes that attempting to regulate all risks away will not only have a negative impact on investor's returns but will be outright impossible. Furthermore, risk and return should never fall apart: an asset manager or investor taking a higher risk expecting a higher return has to take the loss in case the investment fails. This cannot be shifted to the depositary.

## Specific remarks

### **I) Delegation of custody – insolvency law**

The banking industry favors an alignment of the UCITS provisions in respect of the delegation of depositaries' tasks to the AIFMD's provisions. Furthermore, the EBF highlights that the AIFMD's provisions on the delegation of depositaries' tasks are already a comprehensive and appropriate set of rules that ensure investors protection. Nevertheless, the UCITS V proposal introduces a new condition in Article 22 (7e) for depositaries related to third party insolvency where the safekeeping duties are delegated to a sub-custodian.

The EBF, believes that this sub-paragraph is unclear, in particular, how a depositary might determine in advance of appointing a delegate how the insolvency rules in the jurisdiction of such a delegate (which need not be an EU jurisdiction subject to harmonized rules as would be the case in respect of the depositary itself) might apply, depending on the circumstances surrounding any insolvency and the manner in which the third party has dealt with the assets entrusted to it.

In this respect, the EBF stresses that one beauty of UCITS funds is that they are allowed to invest in a great number of countries notably outside the EU and they do so at the request of some investors because they choose to have exposure to certain markets. It is therefore a necessity to appoint sub-custodians in these jurisdictions. The EBF reiterates the importance of allowing for cases where delegation cannot easily be avoided, notably custody of securities issued outside the EU. In such a case, the depositary has little choice over the use or selection of a sub-custodian.

Under the current draft AIFMD level 2 measures, in case of insolvency of the sub-custodian, when the local insolvency law does not recognize the effects of the assets' segregation, the depositary is discharged of the liability. However, under UCITS V, the depositary will be liable for the loss of the assets under the above-mentioned circumstances. The EBF therefore, believes that the prohibition to delegate to a sub-custodian should be at least restricted and apply only to these countries where the depositary is ascertained without doubt that in the event of insolvency of the third party the assets of a UCITS held in custody by this third party will not be available for its distribution.

If the strict prohibition to delegate as currently drafted in the Commission proposal remains unchanged, it is likely that depositaries will not accept to appoint sub-custodians in many countries where there is not legal certainty and UCITS may have to renounce investments in many emerging markets (see Annex I – Amendment 1).

## **II) Supervision and prudential requirements**

Whilst the EBF is in favour of a far-reaching alignment with the AIFMD, the EBF is of the opinion that a depositary should not be allowed to appoint sub-custodians in countries where the sub-custodians are not subjected to an effective prudential regulation, including minimum capital requirements, and supervision in that jurisdiction. Depositaries already demand in the current market practices these requirements (Article 22 paragraph 7 (b)) must be met by their sub-custodians and it is therefore not expected that this will reduce significantly the geographical coverage.

## **III) Liability regime - Contractual discharge**

The European banking industry favors full harmonization of depositaries' liability for cases of negligence or intentional failure to perform its duties. The EBF reiterates the need to align the UCITS V liability regime to the AIFMD regime. Furthermore, the liability regime under the AIFMD has already significantly strengthened the responsibility and liability of depositaries, it may be considered as a benchmark beyond which it is unrealistic to proceed.

The Commission's proposal states that 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.

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. As highlighted in the section one, the EBF believes that the depositary must not be held liable for events related to the sub-custodian, in particular where the local insolvency law does not allow the return of the assets lost in case of the insolvency of the sub-custodian.

The Federation considers it important to acknowledge that a depositary does not have an insurance function. The possibility of contractual discharge of liability as foreseen in the AIFMD should be maintained, also in the case of UCITS.

Concerning the definition of external events, the EBF considers that it should be consistent with the AIFMD requirements set out in Article 102 (2) of the draft level 2 Regulation. In addition, the EBF believes that legal certainty would be reinforced if a reference to the Acts of God and Acts of States - such as nationalizations, national laws, decrees - are included in the recitals 21 and 22 of the draft UCITS V text (see Annex I – Amendment 2).

#### **IV) Depositary eligibility**

Under the Commission proposal only credit institutions and investment firms will be allowed to act as UCITS depositaries. For other types of entities currently providing depositary services, a two year transition period is suggested.

The majority of EBF's members in civil law countries are in favor of the Commission's approach arguing that these two types of institutions provide sufficient guarantees in terms of prudential regulation, capital requirement and effective supervision. However, EBF's members in common law countries believe that UCITS depositaries that are already authorized and supervised in a Member State and are neither credit institutions nor investment firms should continue to be UCITS depositaries as it has been the case until now and the new requirements apply to depositaries authorised going forward.

#### **V) Liability for improper performance of oversight duties**

Recital 7 of the draft UCITS V text contains a provision whose intention is to clarify the liability of depositaries in the event that UCITS assets are lost in custody or in the case of improper performance of their oversight duties. In the latter case, the recital states that 'Such improper performance may result in the loss of assets but also in the loss of the value of assets, if, for example, a depositary tolerated investments that were not compliant with the fund rules, while exposing the investor to unexpected or anticipated risks'.

However, it is unclear what is meant by a depositary "tolerating investments that are not compliant with fund rules" and further clarification would be welcomed. On this respect, the EBF would like to stress that the UCITS manager is primarily responsible (and accountable) for ensuring that the fund remains compliant with its investment restrictions as laid out in the offering documents, both pre-trade and post-trade.

The role of the depositary is to ensure that the manager is not breaching the investment limits of the fund on a post-trade basis. Where the manager has deliberately breached a stated investment limit (i.e. an active breach), it is responsible for rectifying the position and compensating the fund and its unitholders for any losses incurred. The depositary's role is to oversee this process and ensure that the fund and its shareholders are made whole should this type of breach and loss occur. The depositary does not provide a pre-trade vetting of proposed investments. As long as a depositary has properly performed its oversight duties, it should not be liable for a breach by the manager that results in a loss in value of assets. In case such loss occurred, it should be borne by the manager and not by the depositary as the manager is the responsible for the investment decisions.

Furthermore, this recital is not included in AIFMD and the depositary oversight responsibilities contained at Level 1 legislation are identical in the case of AIFMD and UCITS. The EBF

therefore believes that application of these requirements should be identical (see Annex - Amendment 3).

## **VI) Other issues**

### *A) Prospectus disclosure*

According to the Commission's proposal, the UCITS' Prospectus must contain a description of any safe-keeping functions delegated by the depositary, the identification of the delegate and any conflicts of interest that may arise from such delegation.

The EBF agrees in principle that investors receive all relevant information about potential risks related to their investment. In this respect, the AIFMD contains a provision (Article 23 paragraph 1.f) stipulating that this information must be provided to investors, not that it must be contained in the prospectus as the draft UCITS V proposal proposes. It is unclear how depositaries will be able to communicate all approved or/and possible delegation of custody in the Prospectus due to the rather static character of this type of document. The information of all the entities involved in the sub-custodian network may be subject to several changes during the life of the fund. The Federation believes that this information could be given in general terms without unnecessary and confusing details (see Annex I – Amendment 4).

### *B) Invoking claim*

Concerning investor redress, the Commission proposes (Article 24.5) that “Unit holders in the UCITS may invoke the liability of the depositary directly or indirectly through the management company.” The EBF however notes that the AIFMD wording states that “Liability to investors may be invoked directly or indirectly through the management company, depending upon the legal nature of the relationship between the depositary, the management company and the investors”. The wording between both pieces of legislation is therefore inconsistent. Furthermore, it is also inconsistent with section 2.5 of the UCITS V's Explanatory Memorandum which states that the right to invoke claims should depend on the legal nature of the relationship between the depositary, the management company and the unit-holders.

The EBF believes that the provisions in relation to investor redress should be consistent across UCITS and AIFMD structures and that the legal nature of the relationship between the parties should continue to govern the ability to pursue a direct claim. Accordingly, the EBF would recommend that the UCITS V text is amendments in order to be consistent with the AIFMD (see Annex I – Amendment 5).

### *C) Investor Compensation Scheme*

Recital 24 of the draft UCITS V text, contemplates the application of the investor compensation scheme as set out in Directive 97/9/EC (the “ICSD”) to UCITS. The EBF would support the view of the European Council and European Parliament that the application of the ICSD regime to UCITS would result in cost implications for UCITS without necessarily strengthening the investor protection regime. Depending on the outcome of discussions on this point, we presume reference to this directive will be removed from the UCITS V text if UCITS are carved out from the scope of ICSD (see Annex I – Amendment 6).

### *D) Reporting of breaches*

Recital 29 of the proposed UCITS V text states that in order to detect potential breaches, competent authorities should be entrusted with the necessary investigatory powers, and should establish effective mechanisms to encourage reporting of potential or actual breaches.

The EBF believes the emphasis should be placed on actual breaches. Potential breaches do arise and typically these are investigated to establish whether or not an actual breach has arisen. Where an actual breach is deemed to have arisen, this will be subject to the usual resolution process. Furthermore, any reporting should cover only actual breaches. The same principle is followed in Article 99d of the proposed Directive.

### *E) Terminology*

The EBF believes that the terminology used in UCITS IV should be in line with the proposed UCITS V. In this respect, Article 22 (5), 22 (6) and 22 (7) refer indistinctly to assets and financial instruments. We understand that assets in custody as meant in Article 22 refer to financial instruments and we would recommend aligning the wording with the UCITS IV proposal and substituting assets by financial instruments.

**ANNEX I: Proposals for amendments**

<b><u>Amendment 1 - Delegation of custody</u></b>	
EC proposal Article 22 – paragraph 7 d	EBF proposal Article 22 – paragraph 7 d
(d) segregates the assets of the clients of the depositary 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.	(d) segregates the assets of the clients of the depositary 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. <b>Where it is only ascertained without doubt that according to the applicable law of the third party, in the event of insolvency of the third party the assets of a UCITS held in custody by this third party are available for distribution among or realization for the benefit of creditors of the third party, condition (d) is not deemed to be met as segregation will not be effective."</b>
EC proposal Article 22 – paragraph 7 e	EBF proposal Article 22 – paragraph 7 e
(e) in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among or realisation for the benefit of creditors of the third party;	<del>(e) in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among or realisation for the benefit of creditors of the third party;</del>



**Amendment 2 – External event**

EC proposal Recital 21	EBF proposal Recital 21
<p>(21) It is necessary to specify and clarify the UCITS depositary's liability in case of the loss of a financial instrument that is held in custody. The depositary should be liable, where a financial instrument held in custody has been lost, to return a financial instrument of the identical type or of the corresponding amount to the UCITS. No further discharge of liability in case of loss of assets should be envisaged, except where the depositary is able to prove that the loss is due to an 'external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary'. In this context, a depositary should not be able to rely on internal situations such as a fraudulent act by an employee to discharge itself of liability.</p>	<p>21) It is necessary to specify and clarify the UCITS depositary's liability in case of the loss of a financial instrument that is held in custody. The depositary should be liable, where a financial instrument held in custody has been lost, to return a financial instrument of the identical type or of the corresponding amount to the UCITS. No further discharge of liability in case of loss of assets should be envisaged, except where the depositary is able to prove that the loss is due to an 'external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary'. <b>Both acts of State and acts of God are considered as external events beyond reasonable control. Examples of acts of State are nationalisation, national laws, Government or Government agency decisions which impact the financial instruments held in custody. For instance, in the context of the insolvency of a third party to whom custody was delegated, the law of the country where the instruments are held in custody, which does not recognise the effects of an appropriately implemented segregation, is deemed to be an external event beyond reasonable control. On the contrary, <del>In this context,</del></b> a depositary should not be able to rely on internal situations such as a fraudulent act by an employee to discharge itself of liability.</p>

<b><u>Amendment 3 - Liability for improper performance of oversight duties</u></b>	
EC proposal Recital 7	EBF Proposal Recital 7
In order to ensure the necessary level of harmonisation of the relevant regulatory requirements in different Member States additional rules should be adopted defining the tasks and duties of depositaries, designating the legal entities that may be appointed as depositaries and clarifying the liability of depositaries in cases UCITS assets are lost in custody or in the case of depositaries' improper performance of their oversight duties. Such improper performance may result in the loss of assets but also in the loss of the value of assets, if, for example, a depositary tolerated investments that were not compliant with fund rules, while exposing the investor to unexpected or anticipated risks. Additional rules should also clarify the conditions under which depositary functions may be delegated.	In order to ensure the necessary level of harmonisation of the relevant regulatory requirements in different Member States additional rules should be adopted defining the tasks and duties of depositaries, designating the legal entities that may be appointed as depositaries and clarifying the liability of depositaries in cases UCITS assets are lost in custody or in the case of depositaries' improper performance of their oversight duties. <del>Such improper performance may result in the loss of assets but also in the loss of the value of assets, if, for example, a depositary tolerated investments that were not compliant with fund rules, while exposing the investor to unexpected or anticipated risks.</del> Additional rules should also clarify the conditions under which depositary functions may be delegated.

<b><u>Amendment 4 - Prospectus disclosure</u></b>	
EC proposal Annex I, schedule A point 2	EBF Proposal Article 23, paragraph 2
A description of any safe-keeping functions delegated by the depositary, the identification of the delegate and any conflicts of interest that may arise from such delegation.	A description of any safe-keeping functions delegated by the depositary, <del>the identification of the delegate</del> and any conflicts of interest that may arise from such delegations <b>and a statement that the list of delegates will be made available to investors on request.</b>

<b><u>Amendment 5 - Investor redress</u></b>	
EC proposal Article 24, paragraph 5	EBF Proposal Article 24, paragraph 5
Unit holders in the UCITS may invoke the liability of the depositary directly or indirectly through the management company.	<del>Unit holders in the UCITS may invoke the liability of the depositary directly or indirectly through the management company.</del>  <b>Liability to investors may be invoked directly or indirectly through the management company, depending upon the legal nature of the relationship between the depositary, the management company and the investors.</b>

<b><u>Amendment 6 - Investor Compensation Scheme</u></b>	
EC proposal Recital 24	EBF Proposal Recital 24
24) On 12 July 2010 the Commission proposed amendments to Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor compensation schemes. It is essential that that the proposal of 12 July 2010 be complemented by clarifying the obligations and the scope of the liability of the depositary and the sub-custodians of UCITS with a view to provide a high level of protection for UCITS investors where a depositary cannot meet its obligations set out in this Directive	Deleted