German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comment

on the Proposal for a Directive amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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General

The German Banking Industry Committee (GBIC) takes the liberty to comment on the Proposal for a Directive amending Directive 2009/65/EC (UCITS V) as follows:

Our preferred position is that the AIFMD proposals are replicated in UCITS V as regards the Depositary provisions. However, the approach taken in the draft UCITS V text of aligning AIFMD and UCITS will mean that the final positions taken in respect of any open points at AIFMD level will have a significant impact on the UCITS regime.

Please see below our concerns with regard to the UCITS V proposal and where it differs from the AIFMD.

1. Liability for improper performance of oversight duties – Recital Clause 7 – Page 11

Recital 7 of the draft UCITS V text contains a statement that the 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“. It is not clear as to what is meant by a depositary tolerating investments that are not compliant with fund rules and some clarity on this would be beneficial. However, it is important to note that the 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 one of oversight 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 advertent/active breach), it is responsible for rectifying the position and compensating the fund and its unitholders for any losses incurred. Again, 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. Such loss should be borne by the Manager. It is not correct that the Depositary should be liable to compensate the fund for advertent investment breaches caused by the Manager. This recital was not included in AIFMD and the depositary oversight responsibilities contained at Level 1 legislation are identical in the case of AIFMD and UCITS. As such, the application of these requirements should be identical. We believe that the following amendment should be made.

Current EC Proposal **Recital 7**	Suggested GBIC 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 financial instruments 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.

2. Discharge of liability where a delegate is appointed – Explanatory Memorandum – 2.4 Rules on Liability (Page 8) & Article 22(7) (Page 22)

Article 21(13) of AIFMD allows for a discharge of liability of a Depositary when delegating its custody functions to a third party in certain circumstances. However, Article 24(2) of the draft UCITS V text, in contrast to AIFMD, holds the depositary liable for the return of instruments held in custody, without the possibility to discharge liability by contract. This results in a stricter liability standard under UCITS than AIFMD. In the Explanatory Memorandum, it is argued that this tightening of liability is justified given the investor base of a UCITS fund compared to that of an AIFM. We do not agree with this argument and believe that this additional liability burden will lead to greater costs for UCITS funds which will outweigh the perceived benefits.

In addition, Article 22(7) of the draft UCITS text contemplates a situation where the UCITS or its management company seek to invest in a jurisdiction which requires certain financial instruments to be held in custody by a local entity but where it is possible that no local entities satisfy the regulation, supervision or capitalisation requirements set out in the UCITS Directive. In this situation, the depositary has no absolute veto power over such investment decision and may be required to appoint a local sub-custodian even in circumstances where it has raised concerns in relation to local custody providers.

A key point that we believe is not sufficiently appreciated by the EU Commission is that the manager of a UCITS retains full fiduciary responsibility for the consequences of its investment decisions to the shareholders of the UCITS it manages and therefore must be subject to a burden proof where the Depositary has expressed its concerns about a local market (which may include concerns about the sub-custodian in that market). In this scenario, where the Depositary is not comfortable taking responsibility for a certain market due to the lack of safeguards, the GBIC believes that the Depositary should not be held liable. It is the Manager who is making the investment decision and given its fiduciary responsibility to the fund shareholders, there is an argument that it should take that responsibility and be held accountable for subsequent losses. We cannot understand why the second half of proposed Article 22.7 sets out a process permitting investment in sub-standard markets - a process involving disclosure to investors and explicit instruction from the manager to the depositary to persist in following through with the investment in the local market despite the disclosed risks - without providing any discharge from liability for the depositary.

We believe that contractual discharge via transfer of liability should be possible in the circumstances discussed above. We therefore recommend that ESMA is given powers to adopt technical standards to define the specific circumstances in which contractual discharge is permitted and to determine the way in which investors are duly informed prior to investment of that discharge and of the circumstances which justify it. The GBIC believes that if such contractual discharge is not possible, this will lead to certain geographical limitations for the investments made by a UCITS, as investment in certain countries will not be undertaken in order to mitigate the risk involved through the sub-custodian delegation and this will restrict investor choice.

3. Requirements to be an Eligible Depositary - Article 23 (Page 23)

Eligibility requirements for fund depositaries is recognised as an important issue for the GBIC. All GBIC members support the Commission's desire to exclude unregulated and low capitalized entities from being authorised to perform or pursue depositaries activities in the EU.

4. Breach Reporting – Recital Clause 29 (Page 15)

The GBIC 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. The GBIC does not see the merit in the competent authorities seeking reports on potential breaches.

Current EC Proposal	**Suggested GBIC Proposal**
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.	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~~ breaches.

5. Invoking Claims against a Depositary – Recital Clause 23 (Page 14) & Article 24(5) (Page 24)

The wording in Article 24.5 of the draft UCITS V text states that "Unit holders in the UCITS may invoke the liability of the depositary directly or indirectly through the management company." 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 is not consistent. It is also inconsistent with section 2.4 of the 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 GBIC believes that the provisions in relation to the invoking of claims 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, we would recommend that the AIFMD text be adopted here.

Current EC Proposal	**Suggested GBIC Proposal**
Unit holders in the UCITS may invoke the liability of the depositary directly or indirectly through the management company.	~~Unit holders in the UCITS may invoke the liability of the depositary directly or indirectly through the management company.~~ **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.**

6. Conditions for the Appointment of a Delegate – Article 22(7)(e) (Page 22)

Article 22(7) of the draft UCITS V sets out the circumstances in which custody and safekeeping functions can be delegated by a depositary to third parties. These largely reflect the equivalent provisions of AIFMD (Article 21(11)). However, one additional condition applying to such delegation has been inserted in Article 22(7)(e) as follows:

> "in the event of the insolvency of the third party, securities held by the third party for UCITS are unavailable for distribution among or realisation for the benefit of creditors of the third party."

It is not clear what is meant by this amendment and, in particular, how a depositary might set about determining 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 harmonised 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 financial instruments entrusted to it. More significantly, imposing requirement (e) on depositaries will lead to severe limitations on the choice of investments for funds since depositaries will be reluctant to offer custody services in most foreign legal environments. The GBIC believes that should this requirement remain in the final text it might lead to

severe limitations for the investments made by UCITS as they may indeed have to cease investing in some countries in order to mitigate the risk involved through the sub-custodian delegation and this may jeopardise the success of the UCITS brand. The GBIC suggests the following:

Current EC Proposal	**Suggested GBIC Proposal**
(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. (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;	(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. **Where it is ascertained 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 realisation for the benefit of creditors of the third party, condition (d) is not deemed to be met as segregation will not be effective.**

7. External Events

The following amendment should be read in relation with amendment N°6.

The GBIC is convinced that it would bring more clarity in the understanding of what should be considered as an external event and also a minimum level of legal certainty to provide a reference in the recitals 21 and 22 to the Acts of God and Acts of States such as nationalisations, national laws, decrees, etc.

In addition, we consider that the definition of external events should be consistent with the AIFMD requirements (see recital 119 and the Article 102 (2) d) of the draft level 2 regulation:

> "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."

Current EC Proposal Recital 21	**Suggested GBIC proposal** Recital 21
(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.	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 financial instruments 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'. **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,~~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.

Current EC Proposal Recital 22	**Suggested GBIC proposal** Recital 22
(22) Where the depositary delegates custody tasks and the financial instruments held in custody by a third party are lost, the depositary should be liable. It should also be established that in case of loss of an instrument held in custody, a depositary is bound to return a financial instrument of identical type or the corresponding amount, even if the loss occurred with a sub-custodian. The depositary shall only discharge that liability where it can prove that the loss resulted from an external event beyond its reasonable control and with consequences that were 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. No discharge of liability either regulatory or contractual should be possible in case of loss of assets by a depository or its sub-custodian.	(22) Where the depositary delegates custody tasks and the financial instruments held in custody by a third party are lost, the depositary should be liable. It should also be established that in case of loss of an instrument held in custody, a depositary is bound to return a financial instrument of identical type or the corresponding amount, even if the loss occurred with a sub-custodian. The depositary shall only discharge that liability where it can prove that the loss resulted from an external event beyond its reasonable control and with consequences that were unavoidable despite all reasonable efforts to the contrary. **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,~~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. No discharge of liability either regulatory or contractual should be possible in case of loss of financial instruments by a depository or its sub-custodian.

8. Obligation for Members States to ensure that the national law protects the financial instruments of the UCITS in case of insolvency of the depositary and of the custodian (art. 22.6) – Page 21

In the case of the insolvency of a depositary located in the European Union and/or where a depositary delegates the custody to an entity within the European Union, the GBIC considers it essential that individual EU Member States take full ownership for ensuring that there are laws in place which allow full investor protection to ensure that financial instruments held in custody are unavailable for distribution among or realisation for the benefit of creditors of the depositary or its EU delegate.

Current EC Proposal	**GBIC proposal**
Article 22 (6) 6. Member States shall ensure that in the event of insolvency of the depositary, assets of a UCITS held by the depositary in custody are unavailable for distribution among or realisation for the benefit of creditors of the depositary	Article 22 (6) 6. Member States shall ensure that in the event of insolvency of the depositary **and/or of any regulated entity which holds financial instruments in custody belonging to a UCITS these financial instruments** are unavailable for distribution among or realisation for the benefit of creditors of the depositary and/or of the regulated entity

9. Making information available to competent authorities on request – Article 1(8) inserting 26a – page 24

We believe that this provision should follow AIFMD. Under AIFMD, a depositary makes information available, upon request, to its competent authority who will, in turn share the information as appropriate with other competent authorities. There is no reason to take a different approach under UCITS.

10. Prospectus disclosure in respect of the depositary network and sub-custodians (Art 1(18) on page 31 and Annex on page 33)

The draft UCITS V text sets out that the prospectus for a UCITS must contain a description of any safekeeping functions delegated by the depositary, identification of the delegate and any conflicts of interest that may arise from such a delegation. This provision corresponds with a similar investor disclosure requirement contained in Article 23 paragraph 1(f) of the AIFMD. However, AIFMD only stipulates that this information must be provided to investors, not that it must be contained in the prospectus. The GBIC believes that this additional requirement, while not consistent with the AIFMD will create an onerous obligation and cost as a UCITS will be obliged to update its prospectus each time it invests in a new market which necessitates the holding of financial instruments through a new sub-custodian.

We suggest the removal of paragraph 2.2 from Annex 1, point 2 of Schedule A and replacement with the following text below:

Current EC Proposal	Suggested GBIC Proposal
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, ~~the identification of the delegate~~ and any conflicts of interest that may arise from such delegations **and a statement that the list of delegates will be made available to investors on request**.

11. Investor Compensation Scheme – Recital Clause 24 (Page14)

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. We 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.

12. Entities at which cash may be placed – Article 1(3) replacing Article 22 new (4) on page 20

The wording is different from the equivalent provision in AIFMD (Article 21(7)). In particular, whereas AIFMD allows cash to be deposited with entities referred to in MiFID Article 18(1)(a),(b) and (c), **or another entity of the same nature** (our emphasis), UCITS V does not allow for placing cash „another entity of the same nature". The GBIC is not clear on why this difference exists and suggests that it is made consistent with the AIFMD.

13. Recital 17 – Omnibus accounts for multiple UCITS (Page 13)

Recital 17 of the UCITS V legislative proposal provides that: "A third party to whom the safe-keeping of assets is delegated should be able to maintain an omnibus account, as a common segregated account for multiple UCITS."

However Recital 40 of AIFMD already requires "**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'.**

The GBIC welcomes the confirmation that third parties to whom the safekeeping of assets is delegated should be able to maintain an omnibus accounts. We note, however, that the last part of that Recital could be interpreted as a requirement for "UCITS only" omnibus accounts and not for Investment Funds which are either AIF or UCITS. We believe there is no reason to maintain separated omnibus accounts one for AIFs and another for UCITS. We would be concerned if such a requirement were introduced without a proper legal analysis and cost benefit analysis having been conducted. The introduction of such a measure could indeed result in a multiplication in the number of accounts to be opened therefore

creating additional operational risk and cost inefficiencies without conferring material benefit in the event of an insolvency within the custody chain.
The GBIC therefore recommends amending the recital 17 as follows:

Current EC Proposal	**Suggested GBIC Proposal**
A third party to whom the safe-keeping of assets is delegated should be able to maintain an omnibus account, as a common segregated account for multiple UCITS.	A third party to whom the safe-keeping of assets is delegated should be able to maintain an omnibus account, as a common segregated account for multiple UCITS **and AIFs.**