European Fund and Asset Management Association

EFAMA Position Paper on the legislative proposal of the Commission amending Directive 2009/65/EC ("UCITS V")

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 26 member associations and 59 corporate members approximately EUR 14 trillion in assets under management of which EUR 7.9 trillion was managed by approximately 54,000 funds at end March 2012. Just above 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org

EFAMA supports the policy objectives that the Commission seeks to achieve with the UCITS V proposal. We are committed to bring our constructive contribution to the legislative debate with a view to ensuring that these objectives will effectively be reached in practice without hampering the factors that have contributed to the worldwide success of the UCITS brand.

GENERAL REMARKS

- Concerning **depositaries**, EFAMA supports in principle the general approach taken by the Commission in providing for consistency between the AIFMD and UCITS depositary frameworks. In particular, we believe that differences in the terminology used in both directives should, as much as possible be avoided unless they are meant to reflect a different policy choice.

- We also agree that a number of adjustments to the AIFM depositary regime may be needed to take into account the specificities of the UCITS investors' base. However, we wish to underline the fact that the depositary regime in the AIFMD already represents a considerable move as compared to the current UCITS Directive in terms of investor protection and harmonization and clarification of the depositary functions and liabilities. It is very important to recognize that this strengthening of the depositary regime will inevitably have an impact on the costs of the depositary function and, therefore, on the returns that investors may expect from their investments in UCITS products. In order to preserve the competitiveness of the UCITS brand, it is therefore essential to find the right balance, bearing in mind that as a basic principle of investing, risk is inherently linked to returns and trying to regulate all the risk away will – if possible at all – have a profoundly negative impact on investor's returns due to associated costs.

- On a related note, EFAMA also wishes to reiterate the serious concerns it had already expressed towards the Commission's proposal to extend the scope of the **Investor-**

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Compensation schemes to UCITS and their unit holders[1]. We are indeed deeply concerned about the important additional costs that this extension would entail. These costs are very likely to be ultimately borne by UCITS unit holders and appear to be disproportionate in comparison to the benefits they would enjoy in terms of increased protection. Furthermore, the proposal of the Commission to extend the scope of the ICSD to UCITS unit holders also takes insufficient account of the legal structure and distribution patterns of UCITS and therefore raises **major legal and practical issues** which are likely to undermine rather than promote investors' confidence.

- Concerning **remunerations policy**, while EFAMA considers that the principles for UCITS Management Companies should be, as far as possible, consistent with those applicable to AIFMs as well as those for banks and other types of investment firms, EFAMA believes that these requirements should not be identical in detail or application. They need to take into account the differences in business models of banks and asset managers. They also need to provide sufficient flexibility to allow for tailoring when applied to individual sectors and individual firms. EFAMA's key concern therefore is for sufficient proportionality. Management companies should be able to apply the principles in different ways according to their size and the size of the funds they manage, their internal organisation and the nature, scope and complexity of their activities. EFAMA therefore welcomes the proposal (Article 14a(4) of the UCITS V proposal) to request ESMA to develop guidelines in order to achieve this objective of proportionality in the application of the principles on remuneration. In order to achieve proportionality, provision should be made to allow for some principles to be neutralized and not applied to UCITS as EBA advises for banks.

- Additionally, EFAMA believes that – as a consequence of the recent adoption of EMIR - there is an urgent need to clarify in the UCITS directive the counterparty limits for OTC derivatives in relation to central clearing. Indeed, in the absence of such clarifications, the existing counterparty limits under Article 52 may actually act as a brake on UCITS moving to central clearing, therefore preventing UCITS and their investors from benefitting from the reduction of counterparty risk associated with central clearing.

[1] for further details, please refer to EFAMA's position paper on the ICSD Review available at: http://www.efama.org/Publications/Public/Investor_Compensation_Scheme_Directive/10-4088_EFAMA%20Position%20paper%20on%20ICSD%20Review.pdf

DETAILED COMMENTS

1. PROVISIONS IN RESPECT OF DEPOSITARIES

Entities eligible to act as depositaries for UCITS

The UCITS V legislative proposal provides that only two categories of entities should be eligible to act as a depositary to a UCITS, namely:

(1) Credit institutions authorized in accordance with Directive 2006/48/EC

(2) Investment firms authorized under Directive 2004/39/EC ("**MiFID**") to provide safekeeping and administration of financial instruments for the account of clients and which are subject to the minimum capital requirements set out under the Directive 2006/49/EC ("**CRD**").

A one-year transitional period (starting from the deadline for transposition of the Directive in National Law) is also foreseen for UCITS to proceed with the replacement of previously appointed depositaries that do not meet the above requirements.

EFAMA supports the overarching objective of the Commission to harmonize the eligibility criteria that currently apply to the provision of depositary services in the various Member States. We believe, however, that the eligibility to provide depositary services should not be restricted to credit institutions and MiFID firms subject to CRD requirements but should also remain open to other types of institutions which are currently authorized to act as depositaries in their jurisdiction provided that they are subject under their National law to similar conditions, in particular in terms of prudential regulation and ongoing supervision.

We, indeed, believe that the most important point is to make sure that all the entities which are authorized to act as depositaries are subject to similar rules, in order to ensure a proper level playing field without undermining the protection of UCITS investors.

Consequently, we are of the view that other types of institutions than credit institutions and MiFID firms which are currently authorized to act as depositaries in their jurisdiction should remain eligible to act as depositaries provided that they are subject to prudential regulation and ongoing supervision and as long as they are subject to rules with the same effects in terms of:

- Capital requirements
- Investor Protection
- Conflicts of interest
- Risk Management.

Additionally, we see some merits in extending the categories of eligible institutions to National Central Banks, as is currently the case in the legislation of some Member States. In exceptional circumstances, Central Banks might indeed play a useful role of "last resort" depositary in particular under the condition that they would also fulfill the above mentioned criteria.

Furthermore, EFAMA considers that Member States should retain the discretion (as is currently the case) to restrict further the eligibility criteria in their own jurisdiction (for instance to decide that only credit institutions are eligible to act as depositaries for UCITS domiciled in their jurisdiction).

Contractual discharge of liability in case of delegation of the custody function

Article 21(13) AIFMD gives the possibility to the depositary contractually to discharge its liability in certain circumstances (and subject to strictly defined conditions) where it has delegated its custody function to a third party. In the light of the needs of retail investors, the Commission has decided not to provide this possibility in the UCITS V legislative proposal, resulting in a stricter liability standard under UCITS than AIFMD.

EFAMA is of the view that the contractual discharge of liability provided for under the AIFMD is in general inappropriate for UCITS given that retail investors are not always in a position to understand the potential consequences of such a discharge.

However, we believe that there may be a number of very limited and exceptional circumstances where such possibility of contractual discharge would be justified, subject to appropriate disclosure to the investors (this might, for instance, be the case in the circumstances contemplated in Article 22(7) of the UCITS V proposal where the UCITS management companies seeks to invest in a country in which the local law requires that certain financial instruments be held in custody by a local entity and no local entities satisfy with the delegation requirements foreseen in that Article).

We therefore recommend giving to ESMA the power to adopt technical standards to define the specific circumstances under which a contractual discharge of liability on a third party would be possible and to determine which measures should be taken in such a manner that the investors of the relevant UCITS are duly informed of that discharge and of the circumstances that justify it prior to their investment.

Conditions for the delegation of the custody functions by the depositary to a third party

Article 22(7) of the UCITS V legislative proposal defines the conditions to be fulfilled in order for the depositary to be authorized to delegate its safekeeping functions to a third party. These conditions are to a very large extent similar to the equivalent provisions in Article 21(11) AIFMD. However, one additional condition applying to such delegation has been inserted in Article 22(7) third subparagraph (e) of the UCITS V legislative proposal following which:

"*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*".

We support the general stance reflected by this additional requirements that UCITS assets must be protected as far as possible from the effects of the insolvency of the sub-custodian. In its current wording, however, the proposed standard is very demanding and which potentially causes situations in which the UCITS depositaries in certain jurisdictions cannot meet these requirements. The provision would in effect mean that the depositary shall be required to stand as guarantor with regard to the efficacy of insolvency law to ensure an appropriate ring-fencing of financial instruments belonging to the UCITS in case of default of a sub-custodian located in a foreign jurisdiction (which need not be an EU jurisdiction subject to harmonized rules as would be the case in respect of the depositary itself).

In some jurisdictions outside the EU, it might be very difficult for the depositary to determine in advance of appointing a delegate how the insolvency rules in the jurisdiction of such delegate might apply. The effects of insolvency can depend to a great extent on the surrounding circumstances and the protective measures undertaken by the third party with regard to the fund assets. Moreover, it should be borne in mind that any assessment by the depositary can only take the form of legal opinions and must not be treated as a guarantee in absolute terms.

As a result, we are concerned that in some instances depositaries will not be able to demonstrate with sufficient certainty that this requirement is fulfilled in practice which will effectively exclude UCITS from investing in certain jurisdictions.

Hence, while not questioning the condition in Article 22(7) third subparagraph (e) as such, we believe that proper account should be taken of situations where the law of a third country does not fully recognize the effects of asset segregation as being insolvency-proof, but on the other hand requires local custody of certain financial instruments. In our opinion, delegation of the custody function in these cases should not be entirely prohibited, but rather made conditional upon the depositary taking additional measures to shield the fund assets from insolvency and the residual risk being duly disclosed to investors. For this purpose, the limited exception Article 22(7) fourth subparagraph could be extended to cover situations under third subparagraph letter (e).

Furthermore, for the sake of clarity and consistency with the terminology used in the UCITS V legislative proposal and, in particular, in Article 22.5(a), we believe that the word "*assets*" in Articles 22.6 and 22.7(e) should be replaced by the words "*financial instruments*" (indeed, as per the distinction made in Article 22.5(a), "*financial instruments*" are the only assets capable of being held in custody).

Redress - Invoking claims against a depositary

Article 24(5) of the UCITS V legislative proposal provides that: "*Unit holders in the UCITS may invoke the liability of the depositary directly or indirectly through the management company"*.

This wording differs from the equivalent provision in the AIFMD, following which: "*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"*. It is also inconsistent with the Explanatory Memorandum (section 2.5), which states that the right for investors to invoke claims directly or indirectly depends on the legal nature of the relationship between the depositary, the management company and the unit holders.

We believe that the provisions in relation to the invoking of claims should be consistent across UCITS and AIFMD and that the legal nature of the relationship between the parties should continue to govern the ability to pursue a direct claim.

Accordingly, we recommend that the text of the UCITS V legislative proposal be aligned with the wording of the AIFM Directive.

Prohibition to re-use assets without prior consent

According to Article 21(10) of the AIFMD, "*[the] assets referred to in [Article 21(8) AIFMD] shall not be reused by the depositary without the prior consent of the AIF or the AIFM acting on behalf of the AIF*."

Given that the re-use of assets is not prohibited under UCITS rules[2], we believe it is of utmost importance that the same obligation to obtain prior consent of the UCITS or its management company be made explicitly applicable also to UCITS depositaries and their sub-custodians.

We therefore recommend that a provision similar to the above quoted paragraph of the AIFMD be inserted in the UCITS V text and be made applicable also to sub-custodians in case of delegation by the depositary of its safekeeping functions to a third party.

Disclosure of the depositary network and sub-custodians in the prospectus

It is stated in paragraph 2.2 of the Annex to the UCITS V legislative proposal that the prospectus of a UCITS must contain, inter alia, "*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*".

Article 23.1(f) of the AIFMD contains a similar disclosure requirement, but with the important distinction that the AIFMD stipulates that this information must be provided to investors but not that it must necessarily be contained in the prospectus.

EFAMA shares the Commission's view that it is legitimate and useful information that should be made available to investors. However, we do not believe that requesting such disclosure to be made

[2] To the contrary, reuse of assets via Securities lending, for instance, is expressly authorised pursuant to Article 51.2 of the current UCITS Directive and its implementing measures.

in the prospectus of the UCITS is appropriate as it would raise significant practical and operational challenges (this might indeed require frequent updates to the prospectus, in particular for funds using a wider custody network because of the geographic diversification of their investments).

Accordingly, we suggest amending the Annex to the UCITS V legislative proposal and aligning it with the corresponding text in the AIFMD in such a manner that this information should be readily available to investors in such a way as to avoid too frequent updates of the prospectus.

Recital 7 – "Improper Performance"

Recital 7 of the UCITS V text mentions that one of the objectives of the legislative proposal is to harmonize and clarify the liability of depositaries in case of loss of financial instruments or in the case of improper performance of its oversight duties. To illustrate possible cases of such improper performance, the recital refers to a situation where "*a depositary tolerated investments that were not compliant with fund rules*" causing a loss in the value of assets.

It is unclear as to what is meant by this reference to a depositary "tolerating" investments that are not compliant with fund rules and there is no provisions in the UCITS V text itself that directly addresses this point.

We also note that there is no similar reference in the Recitals to the AIFMD, despite the fact that the oversight duties of the depositaries (and their corresponding liabilities) are described in identical terms in both directives.

Therefore, in order to avoid legal uncertainties EFAMA recommends deleting from Recital 7 the sentence starting with "*Such improper performance …*".

Recital 17 – Omnibus accounts

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.*"

EFAMA 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 (although it does not clearly result from the text of the UCITS V proposal itself).

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.

EFAMA therefore recommends deletion of this Recital.

2. PROVISIONS IN RESPECT OF REMUNERATIONS POLICIES

It is very likely that in the future most investment management firms in Europe will be holding at the same time an AIFM and a UCITS license (and, should this still be permitted under the AIFMD Level 2, a MiFID license). EFAMA therefore considers that it is important that consistent principles in relation to remuneration policies be applied across those different pieces of legislation.

While EFAMA considers that the principles for UCITS Management Companies should be, as far as possible, consistent with those applicable to AIFMs as well as those for banks and investment firms under CRD and AIFMD, EFAMA believes that these requirements should not be identical in detail or application. They need to provide sufficient flexibility to allow for tailoring when applied to individual sectors and individual firms. EFAMA's key concern therefore is sufficient proportionality. Management companies should be able to apply the principles in different ways according to their size and the size of the funds they manage, their internal organisation and the nature, scope and complexity of their activities. EFAMA therefore welcomes the proposal (Article 14a(4) of the UCITS V proposal) to request ESMA to develop guidelines in order to achieve this objective of proportionality in the application of the principles on remuneration.

EFAMA welcomes the fact that EBA should closely cooperate with ESMA in the development of these guidelines. We believe that the objective to "*ensure consistency with requirements developed for other sectors of financial services, in particular credit institutions and investment firms*" should be pursued. This being said, we would like to point out that consistent requirements does not mean identical requirements. The requirements must take into account that the business model of UCITS Management Companies who are asset managers differs fundamentally from those of credit institutions and other types of investment firms. UCITS Managers as asset managers act as agents managing clients assets and do not trade on their own account. EFAMA therefore considers that duly justified differences should be possible between the remuneration principles applying to UCITS management companies and those applying to credit institutions and other types of investment firms.

In relation to the elements of the remuneration principles where consistency is crucial, EFAMA notes the possibility in the CEBS guidelines to 'neutralise' certain requirements. This ability was specifically extended to firms falling under Article 20(2) of Directive 2006/49/EC (which, of course, already includes those UCITS managers which also perform MiFID activities). EFAMA considers it crucial that the requirements imposed by the amendments to UCITS Directive do not conflict with those imposed by Directive 2010/76/EU. Where a firm would not be required to comply with specific requirements under one Directive, they should not be imposed by a set of standards established for the same policy purpose by a different Directive.

Furthermore, although we are in favour of consistency between UCITS and AIFMD, we believe that a full alignment of the UCITS provisions with the AIFMD remuneration policy rules in terms of disclosure would be inappropriate. In particular, Article 1.11 of the UCITS V legislative proposal – which provides for external disclosures on remunerations policy in the annual report –- is disproportionate for UCITS and we therefore recommend that it should be deleted.

3. PROVISIONS IN RESPECT OF SANCTIONS

EFAMA has no objection in principle to the provisions in the UCITS V legislative proposal seeking to promote convergence and reinforcement of national sanctioning regimes.

4. OTHER ISSUES THAT SHOULD BE ADDRESSED IN THE CONTEXT OF THE UCITS V REVIEW

Central clearing and counterparty limits for OTC derivatives

EFAMA notes that the UCITS V legislative proposal does not provide explicitly for UCITS V to avail of the OTC derivative clearing arrangements provided by EMIR. This issue was raised on several occasions with the Commission during the EMIR discussions and we were assured that it would be dealt with by an amendment in the UCITS directive. Regrettably, this issue is not covered under the UCITS V proposal, even though it precisely fits with its overarching objective – investor protection.

In summary, the issue in question arises for UCITS in relation to central clearing and counterparty limits for OTC derivatives as defined in Article 52 of the current UCITS Directive. According to that provision, UCITS have a 5% limit on exposures to a single counterparty on OTC derivatives (raised to 10% where the counterparty is a credit institution). However, there is an urgent need to clarify how these limits apply in the context of central clearing through CCPs and, in particular, as to who the counterparty is for the purposes of the 5% or 10% limit.

EFAMA requests that clarity be provided on this issue and recommends that the 5%-10% limit be removed for any exposure to a clearing house. Indeed, in the absence of such clarifications, the existing counterparty limits under Article 52 may actually act as a brake on UCITS moving to central clearing, therefore preventing UCITS and their investors from benefitting from the reduction of counterparty risk associated with central clearing.