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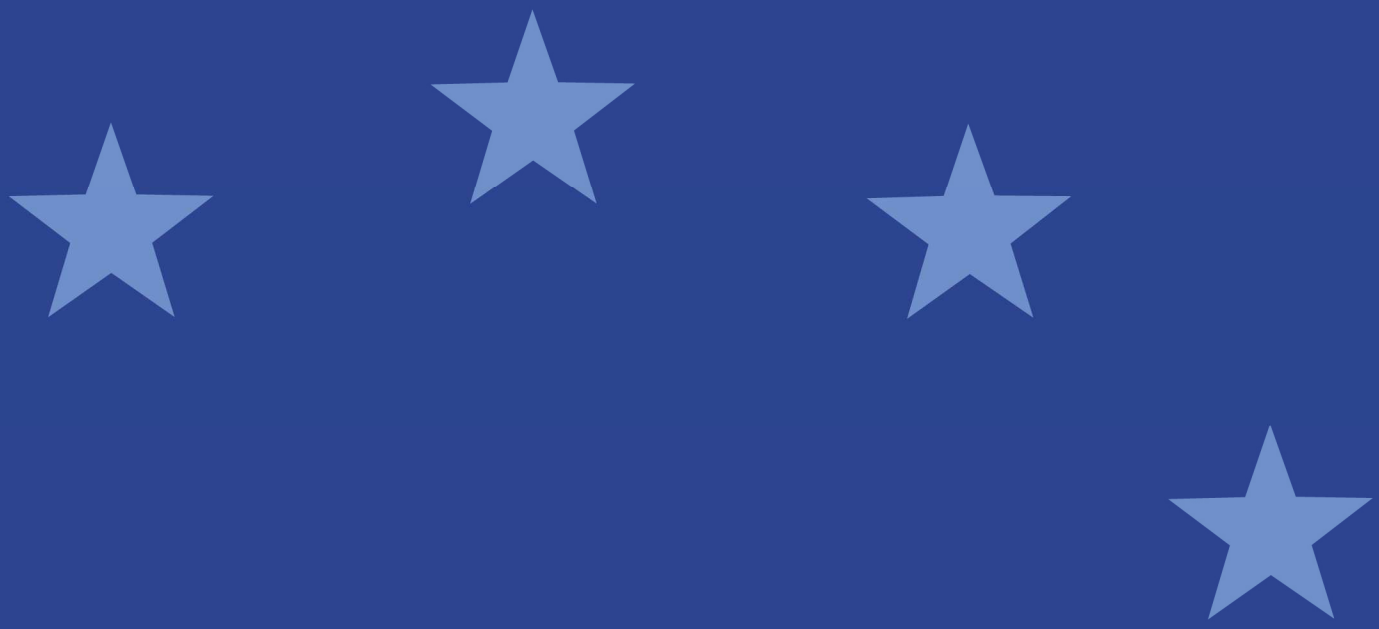
European Securities and Markets Authority

Reply form for the Technical Advice the on delegated acts required by the UCITS V Directive



26 September 2014

European Securities and
Markets Authority

Date: 26 September 2014

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Consultation Paper - ESMA's technical advice to the European Commission on delegated acts required by the UCITS V Directive, published on the ESMA website (here).

Instructions

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, please follow the instructions described below:

i. use this form and send your responses in Word format;

ii. do not remove the tags of type < ESMA_UCITS_QUESTION_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and

iii. if you do not have a response to a question, do not delete it and leave the text "TYPE YOUR TEXT HERE" between the tags.

Responses are most helpful:

i. if they respond to the question stated;

ii. contain a clear rationale, including on any related costs and benefits; and

iii. describe any alternatives that ESMA should consider

Given the breadth of issues covered, ESMA expects and encourages respondents to specially answer those questions relevant to their business, interest and experience.

To help you navigate this document more easily, bookmarks are available in "Navigation Pane" for Word 2010 and in "Document Map" for Word 2007.

Responses must reach us by **24 October 2014**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input/Consultations'.

Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Disclaimer'.

III. Advice on the insolvency protection of UCITS assets when delegating safekeeping (Art. 22a(3)(e)[1] and 26b(e) UCITS V)

Q1: Do you agree that the steps to be taken by the third party are ultimately intended to ensure that the level of segregation foreseen under 22a(3)(d) of the UCITS Directive is recognised in the context of an insolvency proceeding involving the third party?

<ESMA_UCITS_QUESTION_1>

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The German Banking Industry Committee (GBIC) would like to thank you for the opportunity to comment on ESMA's Technical Advice on delegated acts required by the UCITS V Directive. GBIC 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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Yes, generally GBIC does.
However, it is sufficient to differentiate between portfolios held for the depositary's own account and those held on behalf of third parties provided this ensures that the assets can be identified as the property of the customers of a specific depositary at all times. In the event of insolvency, therefore, it must be ensured that the assets can be reclaimed under insolvency law (segregated). Substantive law in the depositary country must therefore provide appropriate procedures. The requirements for technically implementing segregation – which may include omnibus accounts – must be defined in the depositary country and must be based on insolvency protection regulations. Consequently, we do not believe that 'separation' necessarily has to be carried out using separate accounts. The rationale of Art. 22a (3) (d) includes, but is not limited to the establishment of segregated accounts. Separation in the bookkeeping system is sufficient provided that assets held in custody can be attributed at all times by means of unique owner identification and allocation to the owner's portfolio, thereby ensuring that the objective of determining the ownership of each asset is achieved. Simply separating assets without the ability to segregate them in accordance with local law does not improve investor protection. Because the question of protection is a substantive issue of national law, EU member states/non-EU member states need to establish the requirements for investor protection. If they do not, such a measure would significantly increase settlement risk, which cannot be beneficial for investors or improve the protection of investors.

The steps that must be taken by third parties should include ensuring that segregation is recognised even if the third party becomes insolvent. In this case, among other questions and aspects of safe custody, effective segregation in insolvency is a crucial matter that in the end should largely be achieved by action instigated by the third party. Acting as a depositary and/or its delegated third party means to provide an ancillary (investment) service according to Annex I Section B (1) of Directive 2014/65/EU on markets in financial instruments (MiFID II). Practical experience shows that nearly all depositaries in the EU – credit institution and investment firms – also provide investment services according to Annex I Section A of Directive 2014/65/EU and therefore are subject to this Directive regarding the depositary business; Art. 6 (1) of this Directive excludes the granting of an authorisation solely for the provision of ancillary services. Art. 1 (6) (a) of the UCITS V Directive generally confirms this. Therefore, reference is made to the specific requirements of its Art. 16 Organisational Requirements, especially to its sections (8) – (10) and (11)

[1] Article 22a(3)(d) in the text of UCITS V published in the Official Journal.

subpara. 2 MiFID II and the corresponding 2. Level CP ESMA/2014/549 regarding Safeguarding of client assets. This intended respective final technical advice shall be used as basic regulation also with regard to the present technical advice. Regarding the unavailability of assets of a UCITS in case of an insolvency of the depositary/the third party, especially the questions of custody liens and similar rights should also be taken in consideration.

In order to provide a level European playing field for depositaries, to avoid different supervisory and organisational standards regarding client asset protection and different high-cost modified depositary processes for each MiFID I, MiFID II, AIFM- and UCITS-Directive, the organisational requirements and codes of conduct of MiFID II should be taken as basic requirements. There is no reason to establish different basic standards for safeguarding client assets/financial instruments of individual retail investors, professional investors, AIF- and UCITS-Funds. This necessity also applies to the non-binding IOSCO Recommendations. Therefore, the rules of UCITS V Directive should be clarified in harmonisation with MIFID II and AIFMD wherever possible and additional on top rules established only where Level I provisions are mandatory.
<ESMA_UCITS_QUESTION_1>

Q2: Do you consider that the level of segregation foreseen under Art 22a(3)(d) of the UCITS Directive should protect UCITS assets from claims by creditors of an insolvent third party which had been delegated the safekeeping of the assets by the UCITS' depositary?

<ESMA_UCITS_QUESTION_2>
Separation as defined by article 22a (3) (d) is sufficient for assets to be segregated in the event of insolvency. This requires unique identification and attribution of the assets to the eligible entity. There is no question that custody accounts and deposit accounts maintained as client portfolios at sub-custodians are eligible for segregation from the outset and, as a result, are beyond the reach of any creditors of the sub-custodian.
<ESMA_UCITS_QUESTION_2>

Q3: Are there other measures which could also help achieve this objective?

<ESMA_UCITS_QUESTION_3>
Please refer to the answer to question 1; provided the country in which the securities are ultimately held in custody recognises that separation indicates attribution of ownership in the event of insolvency, no further measures are needed.
<ESMA_UCITS_QUESTION_3>

Q4: Do you agree with the steps to be taken by the third party as identified above? If not, please explain the reasons.

<ESMA_UCITS_QUESTION_4>
Please refer to the answer to question 1; as demonstrated, we generally believe it is sufficient for sub-custodians to separate assets held in custody from their own assets and to hold third-party assets as omnibus accounts. This must also be recorded in the bookkeeping system. No further arrangements are required. However, we believe the requirement under clause 19 of the consultation paper stating "The third party should ensure that the relevant conditions foreseen by these laws are met both ...at the moment of the conclusion ... and on an ongoing basis..." would be difficult to implement. Correctly, only the application of standard regulatory rules will ensure that custody is safe. Bilateral agreements may not be used as the basis for compliance with regulatory law. Besides which, contractual provisions are difficult to negotiate, demand and/or enforce outside the EU single market.

Comments on Principles 1-3 of the IOSCO recommendation (clause 23 of the consultation paper): Custody accounts and deposit accounts are already run properly. This also includes the preparation of account statements (sometimes in a purely technical form). Consequently, we do not believe further arrangements are required. In connection with the term 'client', we understand that it only refers to the

owner of the relevant custody account within each individual custodial relationship , and not - along the whole custody chain - the individual who is the depositary's ultimate customer. The preparation of custody and deposit account statements at individual client level would be virtually impossible for each sub-custodian, nor do we believe it would be sensible. The reconciliation process that has been implemented ensures that books and records are kept properly at each level. It also ensures compliance with the requirement to "minimise the risk of loss and misuse" (Principle 3).

We believe the rule presented in clause 24 of the consultation paper is problematic (no. 2 in the guidance on IOSCO Principle 3). In our view, this requires regular 'analysis' within each custodial relationship. Information relating to assets is already passed on as the result of contractual requirements. In view of this, further regulation is not necessary. We also believe this task is the responsibility of the asset management company in its capacity as the investment decision-maker. We believe it is sufficient to 'merely' provide the asset management company with information about basic changes that affect each special fund. Nevertheless, a customer's entire portfolio is never disclosed to the intermediary (total portfolio is held in custody by several sub-custodians), so such analysis could only ever be a partial view (e.g. Lehman bond in portfolio while investor has entered into a CDS on Lehman default).

In general we regard the IOSCO Recommendations and in particular the three Principles (see Rec. 23 above) as a reasonable starting point. However, it has to be considered that the definition of “client assets” given in the IOSCO Recommendations does not differentiate between direct and intermediated assets (see IOSCO Recommendations p. 9, Glossary). This could lead to the assumption that also the term “client” encompasses direct and intermediated clients. In the case of UCITS the implicit use of such definition of “clients” may lead to misunderstandings in view of Principle 2, which stipulates that the intermediary (resp. the third party) should provide information to “each client”. In view of the current client information regime of the UCITS Directive, which does provide only direct investor information obligations for UCITS and not the depositary or a third party, Principle 2 should be modified in a way which does not lead to a direct investor information obligation for the depository or a third party.
<ESMA_UCITS_QUESTION_4>

Q5: Do you consider that there are any specific difficulties that may arise in verifying the applicable insolvency regime that makes the proposed rules difficult to be complied with? In particular, do you consider the requirement for the third party located in a jurisdiction outside the Union to obtain independent legal advice could give rise to specific issues?

<ESMA_UCITS_QUESTION_5>
We welcome the clarification of the EU single-market privilege (note 18), which states that insolvency law in the single market is deemed to be safe. For countries outside the EU, we believe that obtaining a legal opinion is a suitable way of determining whether insolvency law in the depositary country provides adequate protection. However, this involves substantial costs, because lawyers have to be consulted and may be liable for the content of their opinion. This risk is generally priced into their charges. Obtaining a legal opinion should be sufficient for the purpose of verifying insolvency protection. The remaining risks in interpreting the specific application of insolvency law to each custodian should not be borne by the depositary. The question arises as to whether a party domiciled in the depositary country should be obliged to prepare an opinion about its depositary country. At any rate, this would avoid the cost of obtaining an opinion being passed on to investors.

Regarding Art. 24 (1) subpara. 3 UCITS V Directive the criteria constituting independent legal advice should be clearly given in the delegated act, especially there should be the mandatory requirements of (i) sufficient insurance coverage for possible (pecuniary) losses suffered by the depositary and the UCITS-investors in case the legal advice is not entirely reliable and correct and (ii) that the adviser is not subject to relevant conflicts of interest. The depositary should be able to decide on the selection of the adviser.

This ought to be contractually enshrined in an appropriate agreement (the provision of legal advice by the third party), which would cause significant problems. The question arises as to how this contractual obligation would ultimately be enforceable in practice and how custodians would deal with third parties failing to meet their contractual obligations. From a practical perspective, this is a particular problem with regard

to existing custody agreements (which are the majority), because the assets under custody already exist or have been acquired.
<ESMA_UCITS_QUESTION_5>

Q6: Do you expect a significant increase in terms of costs that would be faced by the third party delegated entities located in jurisdictions outside the Union in order to obtain independent legal advice on the applicable insolvency regime? If yes, please provide any available data and/or estimation.

<ESMA_UCITS_QUESTION_6>
Yes. Costs will increase significantly. The level of the costs is likely to vary widely from country to country, because insolvency law is very different in the individual countries. Estimates are therefore very difficult at present. However, obtaining and assessing country reports is generally very time-consuming and costly. It may well be the case that individual countries become unattractive as depositary locations. Ultimately, the costs will have to be borne by the investor as part of the overall costs incurred.
<ESMA_UCITS_QUESTION_6>

Q7: Would you suggest requiring the third party to take any further steps which are not foreseen in the draft advice?

<ESMA_UCITS_QUESTION_7>
No, we do not currently believe further steps are required. However, in this context we believe it is critical that Art. 24 UCITS V Directive does not restrict the liability of the depositary to valid independent legal advice and / or any other specific and exhaustive precautions.
<ESMA_UCITS_QUESTION_7>

Q8: Should any specific consideration be given to the scenario where the third party further sub-delegates the safe-keeping of the UCITS' assets in accordance with Article 22a(3), last sub-paragraph of the UCITS Directive (as inserted by UCITS V)? Should the third party take any additional/different steps or measures in this case?

<ESMA_UCITS_QUESTION_8>
Specific requirements are not necessary if custody chains are in the EU single market or outside the EU. The same guidelines should be obeyed even if a further sub-custodian is involved. Consequently, we do not believe further regulations are required in this respect. Any further regulations that are enacted in addition to existing regulations must apply to all the parties involved in accordance with the principle of equal treatment in the custody chain. It should again be noted that the regulations must be proportionate overall and must be enforceable in compliance with the jurisdiction of each depository.

It should explicitly be stated that any sub-delegation requires the prior written consent of the depositary and must be subject to the same technical, legal and supervisory conditions and quality as agreed and practised between the depositary and the third party. There cannot be different terms and conditions in a chain of depositaries. Sub-delegations should only be admissible in case of local mandatory law or covenants. This should be in the interest of every depository being subject to Art. 24 UCITS V Directive.
<ESMA_UCITS_QUESTION_8>

Q9: Do you agree with the steps to be taken by the depositary as identified above? If not, please explain the reasons.

<ESMA_UCITS_QUESTION_9>
The steps generally look appropriate to us. However, the due diligence requirements should not be exaggerated, because the costs will ultimately have to be borne by investors. As a result, we think the suggestion under point 30 that refers to Principle 4 of the IOSCO recommendations is problematic. We think the requirement that "the intermediary should understand the client asset protection regimes and arrange-

ments in every jurisdiction..." is too broad. In our opinion, this cannot require specialists/legal experts to be available for each depositary country. Obtaining legal opinions/country reports should be sufficient. In the absence of a direct legal relationship between the depositary and all sub-custodians in the chain, no duty to review all bilateral contractual provisions can be imposed on the depositary. This clearly exceeds its remit. The same must apply to the intermediate custodians/third parties. In such a case, the legal relationships are not directly with the individual sub-custodians, so they cannot influence the terms of each contract. Consequently, we consider that the guarantee of a "contractual provision allowing the termination of the agreement..." throughout the custody chain is inappropriate.

A basic question in this regard, however, is whether regulation of the depositary by a delegated legal act is still covered by the enabling regulation (detailed provisions are to be made for article 22a (3)d, which is directed at third-party depositaries and the obligations they have to fulfil). If the detailed obligations that depositaries have in order to fulfil the requirements of Art. 22a (3)d in respect of third parties are also set out here, the IOSCO recommendations should only apply to the extent that they create a standard provision in harmony with the remaining provisions of the EU Alternative Investment Fund Managers Directive (AIFMD)/Markets in Financial Instruments Directive II (MiFID II). In which case, the depositary's obligation to understand the investor protection provisions in every jurisdiction should be limited to means such as obtaining external legal opinions, and it should not impose further requirements. Agreeing a right of termination in sub-custodian agreements for depositaries in the event that segregation of assets in an insolvency no longer operates in favour of the client under local national law (because the legislation has changed for example) will be problematic for practical reasons. This is because the securities will then have to be removed from the relevant depositary country as a consequence (i.e. possibly sold) and this is ultimately a management decision that only the fund managers can make. However, it is right to agree a right of termination for the depositary and to inform the asset management company if there are changes in the law that may adversely affect the assets. This has to suffice, because the ultimate decision on investment strategy is made by the management company.
<ESMA_UCITS_QUESTION_9>

Q10: Do you expect any significant one-off and ongoing compliance costs for depositaries in order to take the steps identified above? If yes, please provide any available data and/or estimation.

<ESMA_UCITS_QUESTION_10>
Regardless of the steps that have been proposed, significant costs will in any case be incurred for the process. They largely consist of the costs incurred if a review of any agreements in the custody chain is required and the cost of expert/legal opinions that would have to be obtained on both a regular and an ad-hoc basis. It is not currently possible to obtain accurate data because it depends on the granularity of the regulatory specifications.
<ESMA_UCITS_QUESTION_10>

Q11: Would you suggest requiring the depositary to take any further steps which are not foreseen in the draft advice?

<ESMA_UCITS_QUESTION_11>
No, the steps are adequate. In our opinion, depositaries are already sufficiently aware of the issue of selecting custodians whenever assets are relocated to ensure proper management in their own interest and in the interest of reducing liability risk.
<ESMA_UCITS_QUESTION_11>

Q12: Which measures do you think should be taken by the depositary and/or the investment company/management company in the best interest of the investors once the depositary has informed the investment company or the management company on behalf of the UCITS that the segregation of the UCITS' assets in the event of insolvency of the third party is no longer guaranteed in a given jurisdiction located outside the Union? Would the transfer of the relevant UCITS' assets held by the third party in a non-EU jurisdiction to another

(EU or non-EU) jurisdiction which recognises the segregation of the UCITS' assets in the event of insolvency of the third party/depositary be a possible measure?

<ESMA_UCITS_QUESTION_12>
This could be a possible step to take. However, if insolvency protection in this depositary country is generally being changed to the detriment of investors, relocating the assets to a different depositary in the same country would not help. Transferring assets to another country presupposes that it is possible for the assets to be held in safekeeping in the other country. This is not always the case or it is subject to numerous special conditions that are specific to the country and custodian. Nor can the depositary decide whether to relocate the assets. Its duty is to alert the asset management company and inform it that safe custody is no longer possible in the depositary country. Instigating any further action requires a decision to be made by the asset management company.

The depositary may only inform the management company of the circumstance, that the segregation of the UCITS' assets in the event of insolvency of the third party is no longer guaranteed. Even the option of the depositary to terminate the agreement with the third party without undue delay in case the applicable insolvency laws and jurisprudence of a jurisdiction no longer guarantee the segregation of the UCITS assets in the event of insolvency of the third party, cannot substitute the decision how to proceed in such a case. This decision has to be made by the management company.

Since the management company has to make the decision on how to proceed with the relevant assets, firstly it has to be defined on what grounds the management company has to be forced to act. Are the different view of legal experts with regard to the insolvency protection already grounds to force the depositary to inform the management company? Or is a change within the legal practice in the relevant country cause for such an information? Is the decision of a court of first instance relevant, or only a decision of a court of last instance?

Secondly, it has to be assumed that the original acquisition of the assets of a UCITS was in the best interest of the investors and in fulfilment of the promised investment policy of the UCITS to the investor. It also has to be assumed that the original acquisition of the assets of a UCITS has been implemented at a time, when there was no insolvency risk of the third party. So, if there would be a situation where no transfer of assets to another jurisdiction, which recognizes the segregation of the UCITS`assets in the event of insolvency, would be a viable option due to legal or practical obstacles, the management company would be forced to sell the assets. A sudden disinvestment in these assets due to the information of the depositary to the investment company that the segregation of the UCITS' assets in the event of in-solvency of the third party is no longer guaranteed may lead to a violation of the promised investment policy and therefore would not be in the best interest of the investor. To make things worse, an instant disinvestment upon information of the depositary would lead to the dissatisfactory result that the investor of the UCITS would still trust in being invested in the relevant market, although the disinvestment already would have been implemented.

Therefore the measures to be taken by the management company upon information of the depositary, that the applicable insolvency laws and jurisprudence of the third party no longer guarantee the segregation of the UCITS assets, have to consider on the one hand the interest of the investor, not to bear insolvency risks of the third party. On the other hand the interests of the investors, to be invested in the relevant market as described in the prospectus, have to be considered.
<ESMA_UCITS_QUESTION_12>

IV. Advice on the independence requirement (Art. 25(2) and 26(b)(h) UCITS V)

Q13: Do you agree with the identified links that may jeopardise the independence of the Relevant Entities? If not, please explain the reasons.

<ESMA_UCITS_QUESTION_13>

The presented criteria for independent action of the depositary do not (completely) meet the rationale of Art. 25 (2): there are other / more aspects than the both named and the legal systematics is different.

Chapter IV deals with the obligations / the defined function of the depositary (Art. 22 (3)), its liability (Art. 22 (2); 24) and the legal, technical and internal organisational requirements to be complied with in order to qualify as UCITS depositary, i.e., which are as preconditions mandatorily necessary to properly execute its function as generally defined in Art. 22 (3); 22a; 25). The essential precondition to qualify as UCITS depositary third party is not to simultaneously act as management company and / or investment company, these functions are mutually exclusive. Furthermore a UCITS depositary shall not carry out activities (relating to the UCITS and / or the management company) on behalf of the UCITS that may create the defined conflict of interest, unless the potentially therewith connected conflicts are properly identified, managed, monitored and disclosed to the investors. This means that a depositary as single legal entity is not allowed to execute irreconcilable / incompatible functions, Art. 25 (2). It furthermore implies that any actions within its depositary function on behalf of the UCITS must be free from unmanaged / unmonitored / undisclosed conflict of interest. These two requirements are special cases of the general precondition to act solely in the interest of the UCITS and its investors. Independence therefore means that there are no effective influences of whatever kind that jeopardise the execution of its function solely in the interest of the UCITS and its investors. Therefore the application of Art. 25 (2) UCITS V Directive is neither limited to the two named special cases nor to links of any corporate law and / or corporate law aspects.

Furthermore Art. 26b UCITS V Directive does not include any authorization of the Commission / ESMA to amend or limit, but only to specify the term to “act independently” which is not restricted to depositaries and has a clear, unmistakeable and exclusive reference to the respective function. Generally speaking Art. 25 only imposes a ban on any measure of whatever kind to circumvent the special cases and general principle of acting solely in the interest of UCITS and its investors:

Art. 25 (1) prohibits a certain legal entity or natural person to act as depositary and at the same time as management or investment company. Without additional foundation in fact in the single case Art. 25 (1) does not mean (“act”) that corporate (contractual) law links between a depositary and a management or investment companies are banned generally. This applies especially to shareholdings, cross-shareholdings and group inclusion. Contract and other formal or informal agreements leading to a circumvention are also banned regarding the legislative rationale. A common (operative) management (= same natural person acting as manager for a depositary and a management or investment company) irrespective whether it is based on corporate or contractual law falls within the prohibition of Art. 25 (1).

A natural person acting as supervisor of a depositary itself or as a member of a body of (corporate) supervision regularly acts in the interest of the depositary and own interests / interests of the second legal entity. Only if the natural person or the second legal entity at the same time functions as management or investment company, such supervision falls within the ban of Art. 25 (1).

Art. 25 (2) first para. first sentence constitutes the duty of the depositary and the management company in carrying out their respective functions to act solely in the interest of the UCITS and its investors.

Art. 25 (2) first para. second sentence obliges the depositary and the investment company in carrying out their respective functions to act solely in the interest of the investors of the UCITS.

Art. 25 (2) second para. prohibits the depositary to act on behalf of the UCITS unless the depositary has separated its specific UCITS depositary tasks “functionally and hierarchically” from his other (potentially conflicting) tasks and has an appropriate organisation and management of conflicts of interests according to MiFID in place.

This means that a depositary has to build up a separate internal operative and hierarchical organisation for the UCITS function, which is independently managed and led. This internally separate organisation is prohibited to perform any other tasks that might create conflicts of interest. Any other tasks, i.e. depositary tasks for AIF or standard depositary customers have to be organised in other (completely) separate units. If this first organisational requirement is met, the second precondition must be appropriately estab-

lished: potential conflicts of interest between the separate UCITS function, the separate AIF function, the standard depositary function and other admissible banking and or investment functions must be properly identified, managed, monitored and disclosed to the investors of the UCITS. If both preconditions are met, the depositary may start its activities on behalf of the UCITS. The different rules in Art. 25 have to be followed individually and assessed in the very single case whether there is an circumvention of (2) and (3) second para. and / or a failure to act solely in the interest of the UCITS and / or its investors (2) first para.

Commission mandate exceeded by ESMA - No requirement for abstract independence under company law

At this point, we would like to stress that we believe the draft technical advice on the independence requirement is partly based on an incorrect interpretation of the Commission mandate. Art. 25(2) UCITS V only requires asset management companies and depositaries to 'act' independently of each other; it does not require abstract independence in terms of company law. Such a requirement would also not be compatible with the rationale underlying the last sentence of Art. 25(2) UCITS V, that permits certain privileges provided there is a functional and hierarchical separation between depositary and management functions. This provision would be superfluous if the segregation of functions and hierarchies was in fact not possible due to a requirement for abstract independence. Therefore, Option 1 is not covered by the rationale of Art. 25. It does not per se exclude the option of a depositary performing tasks connected with the UCITS, it only prohibits them if they cause conflicts of interest between the UCITS, the investors and the depositary, and these conflicts of interest – second requirement – are not properly identified, managed, monitored and disclosed to the investors.

Consequently, the empowerment of the Commission in Art. 26b (h) UCITS V does not refer to specifying the conditions for abstract independence. Instead, it concerns the creation of uniform criteria in all member states for ensuring that relevant entities act independently in order to achieve the ultimate objective of Art. 25(2) UCITS V, namely the protection of investors by preventing conflicts of interest.

The legislators specify the investor protection that is required by stating in Art. 25 (2) sentence 3 UCITS V: "A depositary shall not carry out activities with regard to the UCITS or the management company on behalf of the UCITS that may create conflicts of interest between the UCITS, the investors in the UCITS, the management company and itself, unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the UCITS." The legislators themselves therefore define investor protection as properly identifying, managing and monitoring potential conflicts of interest and disclosing them to investors, and they themselves put forward Option 2 that is proposed in the draft advice on cross-shareholdings.

This also tallies with AIFM legislation. A comparison of clause 13 of the preamble to UCITS V and clause 38 of the preamble to the AIFM Directive shows that the wording of both is the same, i.e. that depositaries "should act honestly, fairly, professionally, independently and in the interest of ... the investors". The legislators' intention in enacting UCITS V was to harmonize the rules for UCITS with those for AIFs. The AIFM regime, however, does not require abstract independence of depositary and asset management company, but requires a system for managing conflicts of interest to be established. In order to implement this requirement, fund managers have already devised conflicts of interest policies (comprising the establishment of confidentiality areas; strict separation of personnel; definition of areas of responsibility that prevent members of the supervisory board of one relevant entity being responsible for the operational business of another relevant entity; etc.) andcompliance with these policies is monitored by independent auditors.

The German transformation of the UCITS IV / AIFM Directive (*Kapitalanlagegesetzbuch*) already covers the systematic interpretation of Art. 25. The specific cases of shareholdings, cross-shareholdings and group inclusion are therefore already addressed by the existing mandatory conflict of interests management, i.e. existing detailed and binding internal instructions (first level), compliance (second level) and internal audits (third level controls). Fourth level controls are executed by external auditors during the legally prescribed annual audits of the depositary business.

There is no reason within the UCITS V legislation to deviate from this approach. Especially, since the wording of the provisions in Art. 25 UCITS V and AIFMD is identical, so that it can be assumed that the authors of the Directive did not intend any deviating interpretation.

Resolving conflicts of interest by imposing strict limits on shareholdings is alien to all European investment law and to other European capital investment legislation as well. It would be an unnatural element. The subject was already discussed in detail during earlier UCITS V talks and it was ultimately NOT incorporated into UCITS V. In our opinion it is not acceptable that ESMA, a supervisory authority, is now ignoring the unambiguous decision of the legislator not to stipulate strict independence, and by means of technical advice intends to formulate legislation that goes beyond the legislator's original intention. This also raises significant constitutional concerns. For this reason alone, only Option 2, which was proposed in the draft advice on cross-shareholdings and which is formulated in harmony with the approach under the AIFM regime, can be considered. By contrast the 'stricter' Option 1 no longer falls within the legislator's intent or the empowerment of the Commission in this respect, and it must therefore be rejected as contrary to the law.

Non-proportionality of Option 1

Apart from the above, the requirement for radical separation would not be proportionate either. In Germany alone, more than the half of the depositaries and asset management companies would be affected by this requirement (see page 37 of the consultation paper). The far-reaching consequences and costs for many investment service companies all over Europe, which ESMA itself correctly identified as being 'substantive' (see note 62 of the consultation paper and Annex III), interfere with fundamental rights that are protected by constitutional law and with the legal positions of the companies affected. These rights include the following:

- property,
- freedom of occupation,
- established and exercised business enterprise and
- protection of prior rights.

Interference with these rights/legal positions is only law-abiding if it is also proportionate in each case. In our view, it is extremely doubtful that such a radical separation requirement would be at all suitable for promoting the postulated objective of investor protection.

The implementation of Option 1 would involve significant disruption in the market. In addition, it may not even improve investor protection. At any rate, in situations in which an asset management company is the only customer of a depositary, the risk of influence being exerted as the result of de facto financial dependency might even be greater than if there was merely a relationship under company law. The risk that the depositary would not act solely in the interests of investors, but would pursue other financial interests is not ultimately linked to any corporate law relationship. Moreover, the massive restructuring following an implementation of Option 1 would destroy the proven system of corporate networks that has been in place for decades and which enjoys great confidence among investors.

Proportionality (in the form of 'necessity') must in any case be rejected with regard to Option 1, because Option 2 represents a type of intervention that has less impact on those affected but is just as suitable for implementing investor protection. The system of managing conflicts of interest (including monitoring) that already exists in Germany and is comparable to Option 2 has not produced any substantial weaknesses that would require additional investor protection. Despite the practice of cross-shareholdings and group investments that has prevailed in Germany for many years, we are not aware of any cases in which the independence of the associated entities would not have been ensured by the existing management of conflicts of interest plus internal and external monitoring (incl. by the German Federal Financial Supervisory Authority - BaFin). Option 1 is therefore not necessary and we believe it would actually be unlawful.

A complete and indiscriminate ban of shareholdings, cross-shareholdings and group inclusions as sketched in Option 1 is not necessary to meet the rationale and is disproportionate regarding the detriment and inflicted damages to property and legal positions of institutions.

The drawbacks that would be associated with Option 1 are completely out of proportion to the lower level of improvement in investor protection it would achieve, if it achieved any improvement at all. Furthermore, the strict independence limit of 10 percent has been selected at random. No reasons have been given as to why it must be assumed that the party involved exerts greater de-facto and even 'unlawful' influence above a limit of 10 percent. ESMA has not provided any empirical analysis or other robust indications etc. that this is the case. Given the many requirements and internal and government controls already in place regarding the management of conflicts of interest by financial market participants, there is no apparent reason why it should be assumed that they would behave unlawfully (even criminally in certain circumstances) if their equity investment were more than 10 percent. In addition, no special rights are necessarily conferred by a minority stake such as this, even if the threshold were to be set at 25 percent.

The negative experiences in the Madoff scandal were one motivation for tightening the regulations on independence and conflict of interest management at European level. Finally, we would like to stress that there absolutely were no corporate ties between the asset management company and the depositary in the Madoff case, which means that the requirement for radical separation of both entities does not appear appropriate for preventing events of this type in the future. The absence of any practical examples creates the impression that the measures are to combat an 'abstract risk'. This absolutely cannot justify the gravest impairment of fundamental rights.
<ESMA_UCITS_QUESTION_13>

Q14: Do you consider that any additional links should be taken into account such as, for instance, the existence of any contractual commitment or other relationship which would affect the independence of the Relevant Entities? If yes, please provide details.

<ESMA_UCITS_QUESTION_14>
As referred to above - Q 13 - no.
<ESMA_UCITS_QUESTION_14>

Q15: Do you consider that the cumulative presence of all or some of the identified links is necessary to jeopardise the independence of the Relevant Entities or the presence of any of these links is sufficient to determine a lack of independence?

<ESMA_UCITS_QUESTION_15>
Please refer to our response to Q 13. We are strongly opposed to the ban of cross-shareholdings/group inclusion links as it cannot predetermine a lack of independence of the Relevant Entities.
<ESMA_UCITS_QUESTION_15>

Q16: Do you agree with the proposed option to ensure the separation of the management bodies/bodies in charge of the supervisory functions of the Relevant Entities?

Do you have any alternative options to suggest, taking into account those identified under paragraph 47?

<ESMA_UCITS_QUESTION_16>
Separation at management and executive levels should already comply with the standard. No further separation is required. However, as referred to above – Q 13. Any dilution of / uncertainty regarding the first level regulation should be avoided.
<ESMA_UCITS_QUESTION_16>

Q17: Do you consider that the cap of one third of members of the body in charge of the supervisory functions of one of the Relevant Entities to also be members of the management body, the body in charge of the supervisory functions or employees of the other Relevant Entity is appropriate? Would you suggest any alternative percentage? If yes, please provide the reasons why.

<ESMA_UCITS_QUESTION_17>
As referred to above - Q 13.
<ESMA_UCITS_QUESTION_17>

Q18: Do you have knowledge of any restructuring in the composition of the management bodies/bodies in charge of the supervisory functions of any Relevant Entities that would be triggered by the identified option? If yes, please provide data and an estimation of the one-off and ongoing costs that would be incurred.

<ESMA_UCITS_QUESTION_18>
We do not have any data or statistics about this. However, compared to the two options on cross-shareholding, the implementation of the advice regarding common management / supervision is likely to lead to limited additional costs.
<ESMA_UCITS_QUESTION_18>

Q19: Which of the two identified options do you prefer? Would you suggest any alternative option? If yes, please provide details.

<ESMA_UCITS_QUESTION_19>
For the reasons already stated in our response to Q13 (see above), we believe that Option 1 proposed in the draft advice on cross-shareholdings is unacceptable. The systematics of the Consultation Paper is insofar not in line with first level regulation.

If the current regime needs to be changed at all, Option 2 is preferable. The procedure suggested by ESMA in Option 2 is already in place and has proved successful in practice. The proposal itself shows that in this case ESMA is not questioning whether the management company is independent from the depositary. The controls are effective within the group, as demonstrated by current practice to date. The Compliance function is also required to prevent any conflicts of interest and to monitor this on an ongoing basis. Very generally, it should be noted that there are no known cases in which a connection between management company and depositary resulted in losses to investors. Please note that in the much-quoted Madoff case, portfolio management was outsourced to the depositary, a set of circumstances that is likely to be banned by the UCITS Directive anyway.
<ESMA_UCITS_QUESTION_19>

Q20: Under the second option, do you consider that it would be appropriate to require that – whenever the Relevant Entities are part of the same group – at least one third of the members of the management body of the management company/investment company and depositary should be independent? Would you suggest any alternative percentage? If yes, please provide the reasons why.

<ESMA_UCITS_QUESTION_20>
We believe general measures to prevent conflicts of interest are sufficient. Nonetheless, the proportion of one third probably represents the upper limit.
<ESMA_UCITS_QUESTION_20>

Q21: Do you agree that the concept of independence should be understood as requiring that independent directors should not be member of the management body or the body in

charge of the supervisory function nor employees of any of the undertakings within the group?

<ESMA_UCITS_QUESTION_21>
No, we do not agree. The concept of Independence should not include members of the management body nor employees of undertakings of the group, provided the undertakings are not the depositary, or the asset management company.
<ESMA_UCITS_QUESTION_21>

Q22: Do you have knowledge of the impact that each of the two options identified would have in terms of restructuring the shareholding of any Relevant Entities or finding alternative service providers? If yes, please provide data and an estimation of the one-off and ongoing costs that would be incurred.

<ESMA_UCITS_QUESTION_22>
Option 1 would entail huge costs and a complete transformation of the existing models with a realistic possibility of putting at risk and weakening the overall sector. These costs would ultimately be borne by UCITS investors with no added benefits in terms of protection given the absence of evidenced market failure and given that Option 2 will deliver independence.
<ESMA_UCITS_QUESTION_22>

Annex III

Cost-benefit analysis

Q23: Do you agree with ESMA's approach to discard the second and third options described above?

<ESMA_UCITS_QUESTION_23>
Please refer to our response to Q 13.
<ESMA_UCITS_QUESTION_23>