COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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CESR's response to the European Commission's consultation on the UCITS depositary function

1. Background

The Madoff fraud highlighted an inconsistency in the EU regime of investor protection. While they have the possibility to invest in undertakings for collective investment in transferable securities (UCITS) that are meant to be harmonised by the UCITS directive[1] and for that reason available for sale across the European Union (EU), investors are granted a level of protection that may depend on the nationality of the fund and the depositary. In particular, the impact of the Madoff fraud on investment funds in the EU showed that Member States implemented and interpreted the UCITS Directive provisions regarding the depositary's status, role and liability as the minimum provided for by the Directive while other Member States have added supplementary obligations. While investigations into the Madoff fraud are ongoing, CESR believes that this situation needs to be improved as it is potentially detrimental to investor protection and therefore unacceptable.

Following the Madoff fraud, CESR carried out a mapping exercise to establish how the various rules on depositary obligations have been implemented in Member States.[2] Also, in February 2009, CESR was requested[3] to advise the European Commission on the measures to be taken by a depositary in order to fulfil its duties in the case of cross-border management situations (Articles 23 and 33 of the modified UCITS Directive[4]). For that purpose, CESR created a technical group which is chaired by the French market authority (AMF). This group was also tasked with establishing whether further clarity is needed on an EU-wide basis on the status, role and liability of UCITS depositaries and, if so, to prepare a recommendation for CESR's Investment Management Expert Group with a view to advising the European Commission on the legislative proposals or modifications that would be required. CESR intended to provide the Commission with such an informal advice by end of autumn 2009.

In the meantime, the Commission has launched its public consultation on UCITS depositaries. Since the scope and topics of this consultation are very similar to the ones on which the CESR technical

[1] Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (85/611/EEC) (OJ L 375, 31.12.1985, p. 3)

[2] A summary of the results of that mapping exercise is included at Annex 1.

[3] On 13 February 2009, the European Commission has requested CESR's assistance on the content of the implementing measures to be taken pursuant to the revised UCITS Directive. The request for assistance is split into three parts:

- Part I – Request for technical advice on the level 2 measures related to the management company passport. The issues covered in this section include provisions on: i) Organisational requirements and conflicts of interest for management companies (Article 12(3)); ii) Rules of conduct and conflicts of interest for management companies (Article 14(2)); iii) Risk management (Article 51(4)); **iv) Measures to be taken by depositaries (Articles 23 and 33)**; and v) On-the-spot verification and investigation (Article 101) and Exchange of information between competent authorities (Article 105);
- Part II – Request for technical advice on the level 2 measures related to key investor information – supplement to the Commission's April 2007 'request for assistance on key investor disclosures for UCITS;
- Part III – Request for technical advice on the level 2 measures related to fund mergers, master-feeder structures and the notification procedure.

[4] On 22 June 2009, the European Council adopted a directive on undertakings for collective investment in transferable securities (UCITS), following a first-reading agreement with the European Parliament. On 13 January 2009, the European Parliament had adopted a legislative resolution amending the proposal for a directive of the European Parliament and of the Council on UCITS (recast).

group has worked with a view to making suggestions to the Commission, CESR considered that it should provide a response to the public consultation.

2. Introduction

CESR welcomes this consultation as it initiates a public debate and discussions on issues regarding divergent interpretations of the UCITS Directive provisions in relation to depositaries. As a starting point, CESR would like to emphasise that UCITS depositaries are a core element of European investment fund regulation. They provide an important element of investor protection which is not present in some other products in competition with UCITS for retail savings.

CESR acknowledges that under the proposed Directive on Alternative Investment Fund Managers (AIFM), the liability of non-UCITS depositaries would be strengthened to include an inversion of the burden of proof and be more detailed. Commissioner McCreevy announced[5] on 28 May 2009 that he '***wants*** *to extend such provisions to UCITS funds*'. Apart from the issue of the inversion of the burden of proof, where there are mixed view among its Members. CESR would like to express disagreement with such an approach for the following reasons. The AIFM Directive proposal is a draft that is under discussion within the European Council and Parliament and, hence, may be amended. In particular, the draft provisions regarding depositaries do not seem consensual at present. Moreover CESR disagrees with the idea of extending the current draft AIFM provisions regarding depositaries to UCITS depositaries as these do not seem appropriate. CESR sets out below what it believes is an appropriate framework for UCITS depositaries.

More generally, only two CESR Members suggest that the European investment fund legislation relating to depositaries should clearly distinguish between:

- retail fund regulation that would encompass a strict liability regime for depositaries; and

- rules for funds that are reserved for professional or sophisticated investors who are capable of carrying out due diligence. These rules would introduce an attenuated liability regime for depositaries, provided that the depositary/custody risk level is made clear to investors.

However, a majority of CESR Members question whether such a distinction would be workable in practice and do not see grounds for differentiating the depositary liability regime according to the type of investor.

3. Why is it crucial to fix the problem?

In Europe, the requirement to entrust the UCITS' assets to a depositary that is in charge of safekeeping is the basis for a high level of UCITS investor protection.

Investors in UCITS are protected from the risk of default of the UCITS manager by the presence of a depositary in the value chain (should the manager default, the depositary which holds the UCITS assets could find another manager or call for an orderly liquidation of the UCITS fund). Finally, there is an additional level of protection from the risk of wrongdoing or fraud by the manager as the depositary is required to comply with the duties of Articles 22 and 32 of the modified UCITS Directive. The question arises as to what would happen if the depositary itself were to default. This risk is perceived as relatively low as UCITS depositaries are generally large financial institutions, and they are required to segregate the UCITS assets under their custody[6] from their own assets. Should the depositary default, the UCITS assets would be identified as belonging to the UCITS and would not be seized by the defaulting depositary's creditors. This system has worked well for almost 25 years in Europe.

[5] Post-Madoff: Commissioner McCreevy initiates clarification of UCITS (Undertakings for Collective Investment in Transferable Securities) regulations regime (EXME09/28.05)

[6] The assets that cannot be kept under custody by the depositary – which are those for which it has record-keeping requirement – would not be lost whether the depositary defaulted.

Then, the Madoff fraud occurred. It highlighted that some UCITS depositaries in Europe may have delegated the custody to a sub-custodian that was in fact an entity which belonged to the Madoff group. The Madoff fraud together with the Lehman default have revealed the existence of a depositary/custody risk for investors, despite the fact that UCITS depositaries are expected to be institutions which investors can trust to keep their savings safe.

The debate and the legal proceedings arising from these episodes have also revealed divergent interpretations of the UCITS Directive. Some CESR Members consider that the depositary cannot be held liable if it can prove that it has correctly performed due diligence on the sub-custodian and correctly monitored its performance putting in place all the required controls. Other Members consider that, in such circumstances, the UCITS depositary remains, in any case, liable for the restitution of the assets even though it has delegated the custody to a third party.

Because of this situation, investors in Europe and beyond may be losing the confidence they have traditionally placed in UCITS. There is a strong need to restore this confidence.

4. How to find a consensus between the two sides of the argument?

It is clear that UCITS assets must be entrusted to a depositary for safekeeping. It is also clear that delegating the custody of part of the UCITS assets to a sub-custodian is an important tool available to UCITS depositaries. For instance, UCITS are permitted to invest in emerging markets and are doing so to an increasing extent. In many of these jurisdictions, the assets must be held by a local/domestic custodian. The depositary is therefore obliged to delegate custody to a local custodian.

A minority of CESR Members advocate that at least retail investors in UCITS should not bear any depositary or sub-custody risk i.e. that a UCITS depositary should always be liable for the restitution of all UCITS assets that it holds under custody, whatever delegation arrangements it has entered into or whichever sub-custodian it uses. This insurance against the risk of failure by the sub-custodian or default has a cost. A rough calculation would show that a full liability regime for UCITS depositaries could be put in place either by envisaging that depositaries substantially increase the fees they charge to UCITS management companies (ultimately borne by investors) or by requiring them to take out a professional insurance policy (which also implies significant costs).

Others take the view that there may be legal circumstances under which a UCITS depositary should not be held liable for the failure or the default of one of its sub-custodians and, therefore, not be held liable for the restitution of some assets it kept under custody. This is to say that UCITS investors may bear a depositary or sub-custody risk that would vary according to the UCITS' investment policy, the robustness and fitness of the sub-custodian, etc so long as the depositary can demonstrate that it has undertaken sufficient due diligence of the custodian/sub-custodian. Were such a risk to be borne by UCITS investors and, notably, by retail investors, it should be clearly explained in the UCITS' prospectus. As it seems that the level of this risk is an essential piece of information that should be given to investors prior to their investment so that they can make informed decisions, this risk, as well as the circumstances under which it might crystallise, should be included in the prospectus within the section setting out the risk and reward profile of the UCITS.

There are mixed views among CESR Members on the model that should be adopted. However, CESR Members agree that the current situation, in which Member States have adopted approaches that range between the two above-mentioned extremes, is no longer tenable. It should be noted that the differences stem directly from the legal system of each country and the principles that regulate the depositary contract in each jurisdiction. The highest priority will be to close the gap between the two approaches on the liability of UCITS depositaries.

In CESR's view, the best response at the European level to the loss of retail investor confidence, caused by the uneven level of protection offered to UCITS investors across Europe regarding the depositary role and liability, consists of:

1. **more clarity;**

2. **more certainty; and**

3. **more harmonisation.**

5. CESR's response to the consultation questions

Question 1: Do you agree that the safe-keeping (and administration) duties of depositaries should be clarified?

Given the need for more clarity, certainty and harmonisation, CESR does agree that the safekeeping duties of UCITS depositaries should be clarified. Indeed, the lack of clarity – or even more the lack of any definition – of the notion of safekeeping is at the root of the problem.

CESR notes that the level 1 UCITS Directive is relatively concise. It provides that UCITS assets must be entrusted to a depositary for safekeeping. However, the Directive does not define what safekeeping is or what sake-keeper's duties are. These provisions date from 1985 i.e. prior to adoption of the Lamfalussy process. As a result, there are no level 2 technical or implementing measures that would detail and complete them. As a result, these level 1 measures have been implemented in a divergent manner.

In its 2004 Communication[7] the Commission had already observed that '*Safekeeping the assets of a UCITS is the first raison d'être of the depositary. But the Directive does not specify the content of its responsibility: is it only in charge of prudential controls over possible external custodians or is it a full-fledge 'keeper' bound by obligations towards the manager and the investors, independently from its controls?*'.

All CESR members regard safe-keeping as involving at least keeping the custody account for the financial instruments in which the UCITS may invest. A majority of Members go beyond such an interpretation and consider that safe-keeping, in addition to custody of financial instruments, means registering in a position-keeping book the UCITS' assets (e.g. OTC derivatives) for which ordinary custody arrangements are not possible.

This has a clear and direct impact on the extent of depositary functions within different Member States and on the extent of the liability of the depositary vis-à-vis the unit-holders and notably the extent of the requirement to restore the assets. There are grounds hence to clarify and harmonise the notion of safekeeping.

CESR takes the opportunity of this consultation to urge European institutions to remedy the lack of a definition of the notion of safekeeping in the UCITS directive.

Question 2: Do you agree these duties should be clarified for each class of assets eligible to the UCITS portfolio?

One third of CESR Members agree that safekeeping duties should be clarified for each class of assets in which UCITS managers may invest. However, a majority of Members stress that such an approach should not result in a varying level of duty placed on the depositary depending on the asset class in which the UCITS invested.

Moreover, CESR notes that the distinction between '*listed financial instruments*' and '*other eligible assets*' that the Commission envisages is not the distinction that is made in practice by industry practitioners or by competent authorities. CESR suggests as an alternative eligible assets that can be kept under custody as distinct from other eligible assets for which only record- or position-keeping is feasible.

[7] Communication COM(2004)207 from the Commission to the Council and to the European Parliament of 30 March 2004 on the Regulation of UCITS Depositaries in the Member States: review and possible developments.

Question 3: Are there any other appropriate approaches?

On this basis, CESR considers that a definition of safekeeping by UCITS depositaries should encompass the two principles set out below:

- overall control of all assets: custody of assets that can be kept and record-keeping and control of the assets that cannot be kept under custody or registered with the depositary. The assets cannot be transferred by the manager/management company without prior knowledge or consent of the depositary. This is not to say that the depositary makes the investment decisions ;

- segregation of the assets from the depositary/custodian's own assets so that they can be identified as belonging to the UCITS in the case of depositary default (bankruptcy), including prohibition of re-use or re-hypothecation of the UCITS' assets by the depositary on its own initiative and/or without the consent of the UCITS (or its management company). In case of custody delegation, these principles should fully apply to the sub-custodian as well as one of the criteria of the due diligence that the depositary must perform prior to delegating custody – see below response to questions 16 and 17.

Further clarification and harmonisation could be provided through suggestions to the European Commission of level 2 measures and elaboration of level 3 CESR guidelines to complement the level 2 technical definition of 'safekeeping' in particular in the field of OTC derivatives.

Question 4: Do you agree to a common horizontal and functional approach of the custody duties on the listed financial instruments, to be applied to UCITS depositaries?

As shown by the CESR proposed definition of safekeeping, this duty is much broader than custody of eligible assets that can be registered with the depositary to be kept in custody.

Question 5: Is there some specificity that may be applicable to the custody functions of a UCITS depositary that should be taken into account?

Yes. Please, refer to response to question 3.

Question 6: Do you agree that the existing supervisory duties of the UCITS depositary should be clarified?

Question 7: If so, what clarification do you suggest?

In the 2004 Communication, the Commission mentioned that, in the negotiations on Directive 2001/107/EC, the Council Working Party envisaged the inclusion of provisions further specifying the depositary's functions. However, this was eventually ruled out, pending prior evaluation of the need to further enhance Community harmonisation in this field.

No changes have been introduced with regard to the duties of depositaries in Articles 22(3) and 32(3) of the new UCITS Directive compared with those set out in Article 7(3) of Directive 85/611/ECC. It is worth noting that this level 1 article is relatively detailed when compared with Articles 22(1) and 32(1).

Most CESR Members believes that the Articles 22(3) and 32(3) are either clear enough or broad enough to allow Member States to impose further requirement where required at national level. Indeed, in transposing the UCITS Directive, Member States have often included in their own regulations a broader and stricter list of tasks for depositaries. For instance, Article 22(3) (c) states that '*A depositary shall* […] *carry out the instructions of the management company, unless they conflict with the law or the fund rules*'. Two CESR Members even require the depository to monitor all decisions made by the asset management company and to be jointly responsible with the asset management company, even if the depositary has not been directly involved in the action that

generated the loss, whereas others consider that the depositary must only monitor the decisions it executes.

Furthermore, fund administration functions such as registrar functions or subscription/redemption clearing and settlement are entrusted to the depositary under its responsibility in some Member States. Conversely, in some countries these functions maybe outsourced on a contractual basis to the depositary.

Some CESR Members do not consider clarifying the level 1 list of supervisory duties of the depositary as a priority.

Other CESR Members take the view that there should be further work done to clarify and detail level 1 provisions on supervisory duties or that level 2 measures implementing Articles 22(3) and 32 (3) could help detail which controls the depositary is expected to perform, or that level 3 CESR guidelines might foster convergence of supervisory practices. This should also be applicable to investment companies.

Question 8: To what extent does the list of supervisory duties need to be extended?

A few CESR Members do not see strong grounds for further extending the list of supervisory duties at level 1.

A few CESR Members expressed the view that the list should be completed at level 1 or elaborated at level 2 to make sure that UCITS depositaries have a duty to report to the competent authority breaches of national law or fund rules that have not been adequately and timely addressed by the UCITS manager/management company. Some CESR Members believe that level 2 measures could clarify that the depositary's supervisory duties encompass controlling that the UCITS manager complies with all limits set out in the fund rules or that regulatory/legal investment restrictions are respected.

Question 9: Do you agree that the 'only one depositary' requirement should be clarified?

CESR believes that a detailed definition of safekeeping and, notably, the first of the two elements constituting such a definition, clearly imply that all the assets of UCITS funds can only be entrusted to one depositary. Indeed, CESR recalls that the UCITS depositary must have an exhaustive and complete overview of the funds' assets to be in a proper position to perform its supervisory duties.

However, as this principle is crucial, it could be clarified in EU legislation. This is without prejudice to Article 113(2) of the new Directive.

Question 10: Do you think that the risks related to improper performance have been correctly identified?

CESR estimates that most risks relating to improper performance have been identified by the Commission in the consultation paper. However, a majority of CESR Members noted that the two sentences (section II. A. 1. (b)) that read '[…] *Provided that the depositary does not keep the assets in custody it may not have an exhaustive view over all the assets that the fund may have invested in. In such cases, the risk is that no appropriate entity has a global view over the fund's assets so that false assumptions can be made regarding the real scope of the fund's portfolio.* […]' are in contradiction with the first section of the consultation paper. Given the definition of safekeeping that is proposed in response to question 3 and the requirements that have been implemented in most, if not all, European jurisdictions, these CESR Members highlight that a situation where a UCITS depositary does '*not have an exhaustive view over all the assets that the fund may have invested in*' would be considered as a breach in law or regulation and sanctionable by the competent authority.

Most of CESR Members take this opportunity to recall that the depositary's supervisory duties regarding fund portfolio valuation require that the depositary ensure that the fund's net asset value is properly calculated by the UCITS manager.

Question 11: Do you foresee other situations where a risk associated with improper performance of the depositary duties might materialise?

CESR notes that operational risks may crystallise in cases of improper performance of the depositary's duties.

Question 12: Do you agree that safeguards against the risk associated with the improper performance of depositary duties, such as requiring that UCITS assets be segregated from the depositary's and sub-custodian's assets, should be introduced?

CESR not only agrees but also strongly recommends that the European Commission introduce as a priority a principle at level 1 clearly requiring that the UCITS' assets[8] be segregated by the depositary from its own assets and, where relevant, by the sub-custodian from its own assets.

CESR suggests that level 2 measures should then be considered to detail what is meant by segregation depending on the type of assets and to make sure that such a principle would be consistent with bankruptcy rules that apply to institutions which may act as a depositary. For instance, a mere segregation through maintaining separate securities accounts within the depositary books may not allow creditors to identify the assets as belonging to the UCITS – and not to the depositary – in the case of default of the depositary (bankruptcy).

Question 13: Do you agree there should be a general clarification of the liability regime applicable to the UCITS depositary in cases of improper performance of custody duties?

Most CESR Members feel that the reference to the draft AIFM Directive is inappropriate. As mentioned in the introduction, this proposal is a draft, the substance of which may be subject to amendment through discussions in the European Council and Parliament. Article 17 of this draft has triggered much discussion on a first analysis by the European Council.

A few CESR Members expressed the view that the burden of the proof should be placed on the depositary as put forward by Article 17 of the draft AIFM Directive. One CESR Member stresses that an inversion of the burden of the proof would be appropriate, but that this would also depend on the outcome of the discussions on the depositary's liability.

However, most CESR Members are not convinced that the inversion of the burden of the proof ('*the depositary can only discharge itself of its liability if it can prove that it could not have avoided the loss which has occurred*') would strengthen protection of UCITS investors if applied to UCITS depositaries. Bearing in mind that in EU jurisdictions the depositary liability regime is enshrined in civil law, they argue that any enforcement of this regime would in any case be subject to a Court decision.

Provided safekeeping and supervisory duties are clearly defined, any national court can correctly interpret the liability attaching to UCITS depositaries. The main problem regarding liability of UCITS depositaries, as highlighted by the Madoff fraud, is the question of the depositary's liability when it has delegated custody of UCITS assets to a third party that subsequently loses them. This is the question that the Commission should answer in a manner that does not lead to divergent interpretation. CESR makes some suggestions on how to do so at the end of its response to questions 16 and 17.

[8] This is not relevant for cash as it cannot be, by nature, distinguished from cash that belongs to the depositary or to the sub-custodian.

Question 14: What adjustments to the liability regime associated to the custody duties of the UCITS depositary would be appropriate and under what conditions?

All CESR Members but one suggest that the priority should be to clarify and harmonise the duties and functions of UCITS depositaries. UCITS depositaries are subject to a minimum standard or level of liability across the EU, while Member States are permitted to impose stricter requirements at national level.

A minority of CESR Members believe that, in the context of the increased cross-border opportunities brought by the UCITS IV directive, harmonisation of the depositary liability regime is a key element in restoring confidence of investors in the UCITS label.

Question 15: Do you agree that the conditions upon which the UCITS depositary shall be able to delegate its duties to a third party should be clarified?

The UCITS Directive states that '*A depositary's liability as referred to in Article 24 shall not be affected by the fact that it has entrusted to a third party all or some of the assets in its safe-keeping*'.

All CESR Members agree that this implicitly means that a UCITS depositary may delegate its custody functions. However, when it delegates such custody functions to a sub-custodian, its liability remains unchanged.

Although it is not explicitly mentioned that a UCITS depositary is not authorised to delegate its supervisory functions, CESR notes that all but a few Members interpret the UCITS Directive as not permitting such a delegation of supervisory functions. Most CESR Members estimate that there is need to clarify that delegation of supervisory responsibilities is not permitted.

Question 16: Under which conditions should the depositary be allowed to delegate the performance of its duties to a third party?

Question 17: Do you agree that the depositary should be subject to additional on-going due diligence requirements when delegating the performance of its duties to a third party?

CESR Members have different levels of requirement with respect to which entities are eligible to act as sub-custodians of UCITS assets and the standards of care and due diligence on such entities.

CESR is unanimous in its recommendation that the conditions under which a UCITS depositary may delegate its custody functions to a sub-custodian should be clarified and strengthened by introducing due diligence requirements.

Most CESR Members believe that the limitations envisaged by the draft AIFM Directive are not appropriate standards for due diligence requirements regarding delegation of custody functions.

In light of the above, CESR suggests the following principles. Level 2 provisions could state that a depositary may entrust UCITS assets under its safe-keeping to a third-party only if it is assured (by due diligence in the selection, appointment and periodic review of the sub-custodian, including ex-ante and periodic/ongoing checks) that the sub-custodian:

- is subject to supervision by a public authority in its own jurisdiction;
- is audited on a regular basis so that independent auditors certify on a regular basis that the assets that have been entrusted to this entity are present;
- segregates the assets it keeps in (sub-)custody from its own assets and is prohibited from re-using or re-hypothecating on its own initiative and/or without consent of the UCITS (or its management company) the assets it keeps in (sub-)custody;

- will properly and correctly perform the duties that are delegated. Its organisational structure and expertise are adequate and proportionate having regard to the specific outsourced activities and the scale and complexity of the relevant UCITS;

- is not subject to conflicts of interest which might jeopardise the independent and due performance of the outsourced activities and the interests of unit-holders.

Furthermore, the UCITS depositary which delegates custody should be required to keep adequate records and documentation of custody delegation. However, one CESR Member favours stricter requirements. For example, in line with the first indent above this Member requires the sub-custodian to be subject to a level of supervision by a public authority in its own jurisdiction which is in accordance with the depositary provisions of the UCITS Directive.

With regard to the above suggestions, it might be possible to have regard to a certain extent to the MiFID level 2 provisions on deposit of client financial instruments (Article 17) and funds (Article 18). Reference to work on due diligence at international level (IOSCO) and EU level (European Commission) might also be considered.

The terms of the debate regarding UCITS depositary liability where custody is delegated

The UCITS Directive clearly states that the depositary's liability is not affected by the fact that it delegates custody functions to a sub-custodian. The question stemming from this rule is whether the depositary might be required to restore the assets that a sub-custodian has lost due to improper performance of sub-custody duties, its failure or even default (bankruptcy).

Some CESR Members currently interpret the Directive provisions as imposing an obligation on the depositary to restore in any case the assets that have been lost by the sub-custodian i.e. that the depositary should be subject to an obligation of result. They acknowledge that this is placing a stringent liability on the UCITS depositary, which allows a high level of investor protection but could prove to be costly.

Other CESR Members consider that the depositary should be subject to an obligation of means i.e. provided that the depositary can prove it has adequately performed the due diligence and that it could not detect that the sub-custodian was failing or defaulting. The Directive refers to a depositary being liable for an 'unjustifiable failure' or 'improper performance', which can be interpreted as where proper due diligence has not been carried out. Such an approach seems less costly for the depositary industry but also less protective for UCITS investors, who may bear a depositary and/or a sub-custody risk in some circumstances. The liability regime could set out very clearly and in a way which is not susceptible to interpretation, the circumstances under which the depositary is responsible for the restitution of the UCITS assets lost by its failing or defaulting sub-custodian and those under which it is not held liable for restitution (limits of sub-custody risk).

As already mentioned, CESR believes that the lack of harmonisation and common understanding of the level of depositary liability, including liability when the custody has been delegated, is damaging for the UCITS image and for investor confidence. Some CESR Members suggest, therefore, that the best policy approach lies with this second position. A liability regime for UCITS depositaries should be clarified so that it is not susceptible to divergent interpretation/implementation. CESR recognises that it is impossible to eliminate all risk from investment products.

Question 18: Do you share the Commission services approach to reviewing the ICSD, to allow UCITS to benefit from a compensation scheme where the depositary defaults?

Question 19: Do you agree that UCITS holders should also benefit from compensation if their custodian defaults and these assets are lost?

The assets of a UCITS are supposed to be entrusted to and kept safe by the depositary as required by the UCITS Directive. This device reassures investors that the default of the UCITS management company will not have an adverse impact on their assets. In the event of a failure by a financial intermediary, through which investors have purchases/sold units in a UCITS, retail investors may be covered by the Investor Compensation Schemes Directive under the conditions[9] set out by this piece of EU legislation.

In case of non-fraudulent[10] default (bankruptcy) of a UCITS depositary that properly segregated assets in its custody from its own assets[11], the UCITS assets cannot disappear, with the noticeable exception of cash. In the light of this, a very large majority of CESR Members believe that applying the ICSD protection to UCITS where the depositary defaults would be misguided for three reasons:

- as already mentioned, the necessary safeguards (regulation, liability and segregation) against default of the UCITS depositary are already in place;

- such an 'insurance' against default of depositaries which keep billions of euros of assets in custody would be possible only at huge costs. Moreover, without prejudice of the outcomes of the impact assessment that should be conducted by the Commission, should it wish to further explore this avenue, these costs seem prima facie disproportionably higher than the benefits expected from such a measure; and

- such an 'insurance' system might be counterproductive. Indeed, UCITS management companies would lose any incentives to select carefully a robust and safe as well as fit and proper depositary before appointing it.

Some CESR Members, therefore, suggest that the Commission should rather explore the avenue of limiting the cash that a UCITS can hold on deposit with its depositary.

Question 20: Do you agree that the general organisation requirements that are applicable to a UCITS depositary should be clarified?

Question 21: If so, to what extent?

Yes. See response to questions 24, 25 and 26 for specific details of requirements that CESR recommends imposing.

In addition, as already implemented by most CESR Members, the UCITS framework should be supplemented by level 1 and level 2 rules that would detail the principle of 'separation and ethical independence' between the UCITS manager and its depositary. Such provisions could stipulate the conditions to be fulfilled when the management company and the depositary belong to the same group e.g. the management company and the depositary should not have more than a limited number of directors in common; the senior managers of each company should be different persons etc. However, two CESR Members would like to go further and prohibit the management company from contracting with a depositary which belongs to the same group.

Question 22: Do you agree that requirements on conflicts of interest applicable to UCITS depositaries should be clarified?

Question 23: If so, to what extent?

[9] The European Commission is currently reviewing this Directive.
[10] Fraudulent depositary bankruptcy would be treated as a major law breach under all EU jurisdictions' regulation.
[11] This is not relevant for cash as it cannot be, by nature, distinguished from cash that belongs to the depositary or to the sub-custodian.

Most CESR Members feel that rules applicable to UCITS depositaries regarding conflicts of interest are not clear or detailed enough. Indeed, the level 1 safeguards set out in the UCITS Directive to prevent conflicts of interest among the management company and the depositary (and the sub-custodian) are very limited. The new Directive, like Directive 85/611/EEC, only sets out the principles of separation and ethical independence between the fund manager and the depositary. In particular, Article 25 of the new UCITS Directive – which reproduces the existing Article 10 of Directive 85/611/EEC – provides that:

- *'no single company shall act as both management company and depositary';*

- *'in the context of their respective roles the management company and the depositary shall act independently and solely in the interest of the unit-holders'.*

The recent Madoff fraud has drawn to the attention of CESR the need to prevent and manage conflicts of interest which may arise in the performance of the business of depositary. Such conflicts of interest may arise in different circumstances, including the following which were outlined in the 2004 Communication of the European Commission:

1. *the depositary itself (or an affiliated entity) undertakes an activity of investment on own account or other activities[12] likely to create antagonism between its immediate profits and commercial interests, or those of its group, and the interest of the UCITS' investors;*

2. *the management company is integrated within a group which may comprise the depositary as well as brokers and the sub-custodian;*

3. *there are common shareholdings or common board/directors membership in the management company and the depositary;*

4. *the management company delegates functions to an entity that has close links with the depositary or even belongs to its group or that has been delegated some functions from the depositary. The situation where one and the same entity has received delegation from the management company and from the depositary is unacceptable, as it is contrary to the requirement for the management company and the depositary to act independently. However, such a situation, within the current legal framework, may be difficult for competent authorities to detect.*

In addition, CESR notes the potential for conflicts in situations where the management company delegates some functions to the depositary when the depositary is supposed to monitor execution of such functions.

In its Communication, the European Commission concluded that '*In light of diverging regulatory and supervisory approaches, progress is needed on convergence of the prudential frameworks, regarding in particular a common typology of conflicts of interests and the necessary prevention and redress measures. This convergence should include the list of the functions that the depositary (or an entity of its group) can receive from the fund manager by delegation and, conversely, the list of the depositary activities which may be delegated*'.

Most CESR Members believe that this convergence has yet to be achieved and suggest that the UCITS Directive and its implementing measures should list and detail the functions that can be delegated to a UCITS depositary or, in other terms, the functions that a UCITS depositary may perform in addition to its mandatory safekeeping and supervisory functions. This could imply that the list and meaning of supervisory duties are clarified (see questions 6 and 7).

[12] For instance, some CESR Members authorise UCITS depositaries to perform the following activities in addition to their depositary function: execution of UCITS portfolio transactions orders; legal advice from the depositary legal department to the management company; UCITS NAV practical calculation; distribution of UCITS units and shares;

CESR proposes equally that adequate conflicts of interest requirements – notably, regarding the potential conflicts of interest between supervisory duties and other delegated functions – should be put in place at level 1 and detailed at level 2. These requirements to identify, prevent or mitigate and, where the case requests, disclose conflicts of interest should be inspired by the MiFID rules.

Question 24: Do you agree that there is a need for clarifying the type of institutions that should be eligible to act as UCITS depositaries?

Question 25: Do you agree that only institutions subject to the CDR should be eligible to act as UCITS depositaries?

Question 26: If not, which types of institutions should be eligible to act as UCITS depositaries, and why?

According to existing Article 8(2) of Directive 85/611/EEC, '*a depositary must be an institution which is subject to public control*'. Article 23(2) of the new UCITS IV Directive provides that '*A depositary shall be an institution which is subject to prudential regulation and on-going supervision*'. Depositary status is not harmonised at EU level as the Directive authorises the Member States to determine which of the categories of institutions shall be eligible to be depositary.

The mapping of the status, role and liability of UCITS depositaries that CESR conducted in early 2009 has shown that there are broadly three kinds of approach regarding which institutions are authorised by Member States to act as depositaries of UCITS:

- in a few Member States, only banks (credit institutions) subject to further capital and/or organisational requirements are eligible;

- in a large group of Member States, only credit institutions and investment firms subject to specific requirements are permitted;

- in some other Member States, entities other than credit institutions and investment firms (e.g. insurance companies, national subsidiaries of EU and non-EU banks, etc.) may act as UCITS depositaries, provided they comply with specific supervisory requirements.

CESR sees merit in some harmonisation in the depositary status; this could take the form of level 1 provisions indicating which institutions are eligible, complemented by level 2 detailing the requirements that should be applicable.

A minority of CESR Members would like to see the eligibility to act as a UCITS depositary limited to credit institutions.

However, other CESR Members suggest that only the institutions that comply with the following requirements should be eligible as UCITS depositaries:

- **prudential and ongoing supervision**;

- **capital requirements**: a few CESR Members believe that considering institutions that are subject to the Capital Requirement Directive (namely credit institutions and investment firms) is a good starting point. However, these Members wonder whether the level of own capital which is required for these institutions by the said Directive is sufficient to cover the specific risks inherent to the function of UCITS depositary. CESR suggests that this point should be assessed in depth. Article 23(2) of the new UCITS Directive, like Article 8(2) of the existing Directive 85/611/EEC, merely provides that a depositary shall '*furnish sufficient financial and professional guarantees to be able effectively to pursue its business as depositary and meet the commitments inherent in that functions*'. As observed by the Commission in the 2004 Communication, '*capital requirements also reflect the level of legal risk incurred by the local depositaries. Their dispersion*

across the EU reflects differences in legal obligations'. The CESR mapping exercise shows considerable divergence in the minimum level of capital requirements for depositaries across Member States. The range is between 5 million euros and 100 million euros, depending also on the institutions which are eligible for the business of depository. This question is connected with that of the depositary's liability. If their liability was clearly and strictly defined as a wide obligation to restore the assets, depositaries should have adequate capital to be able to withstand such a risk[13]. Therefore, harmonisation of capital requirements imposed on the depositary would be a way to avoid a two-tier regime where capital requirements and, as such, the entity's ability to withstand liability depend on the depositary's nationality;

- **organisational requirements**, notably in view of **assessing, preventing and mitigating specific conflicts of interest**. Although the organisation of tasks may impact, in many cases, the depositary's operational risk, the new UCITS Directive, like the existing Directive 85/611/EEC, does not include detailed rules on this matter. Level 2 provisions in the UCITS framework to impose such rules on all institutions acting as depositary in the EU could be envisaged. Limiting the institutions which are eligible for the business of depositary to credit institutions and investment firms could be considered as a way to ensure that UCITS depositaries are subject to harmonised and robust organisational requirements (banking legislation and MiFID). However, prior to exploring this avenue, it should be checked whether credit institutions and investment firms are subject to organisational requirements that fit the purpose of depositary activity and that are applied in a harmonised way across the EU. In the negative, some additional requirements linked to the specific status and role of the depositary should be envisaged in the UCITS framework as they might bring additional clarity and safeguards (such as the responsibility, for the depositary, to assess the soundness of the UCITS management company's organisation and procedures before accepting its duty as a depositary), or the conditions it must satisfy before delegating part of its tasks (see response to questions 16 and 17);

- **asset segregation** rules, including a **ban from re-using** or re-hypothecating the assets it keeps in custody;

- appropriate **infrastructure**, adequate **financial resources** and good **expertise and competences**.

For most CESR Members, such institutions would, de facto, be credit institutions and/or investment firms.

In the 2004 Communication, the Commission concluded that '*The typology of eligible depositary institutions should be made to converge by identifying a specific group of relevant institutions. This might consist of credit institutions and investment firms, subject to additional organisational and resource requirements where appropriate, plus relevant public institutions (Central Banks)*'.

Question 27: Do you agree that additional auditing requirements should be imposed, such as an annual certification of the depositary's accounts by independent auditors?

Subject to an appropriate cost/benefit analysis, CESR agrees that depositaries could be required to appoint an independent auditor, or to ask their existing auditor provided it is independent, to audit on a regular basis (e.g. once a year) the depositary with a view to certifying the presence and materiality of the UCITS assets under safekeeping. This audit should be reconciled with the UCITS audit that is imposed by the Directive. In addition, and also subject to a cost/benefit analysis, where custody is delegated to third parties by the depositary, the depositary's auditor should receive a certification from each sub-custodian's auditor attesting the presence and materiality of the assets under sub-custody (see 2nd bullet point of response to questions 16 and 17).

[13] For instance, in some Members States a UCITS depositary which had delegated safekeeping to the Madoff firm would have been ordered by the competent authority or the Court to restore all the lost assets or to compensate the UCITS, even though the amount at stake would equal several billion euros.

In addition, CESR suggests that such a requirement could be one of the eligibility criteria for institutions to act as depositary.

Question 28: Do you agree that UCITS depositaries should be subject to a specific 'depositary' approval by national regulators?

The CESR mapping shows that there is no common approach on supervision of depositaries, including whether a specific authorisation should be granted by competent authorities to credit institutions or other eligible institution to act as depositaries. However, in practice, a large majority of CESR Members already impose on UCITS depositaries a specific approval by the national competent authorities in addition to the licence for operating depositary or banking duties.

Therefore, CESR agrees that a formal approval to operate as depositary of UCITS by the national competent authorities could be introduced in the UCITS Directive.

In addition, CESR notes that there is no harmonisation regarding the reporting obligations of depositaries vis-à-vis the competent authorities (nor is there such harmonisation for other parties under the Directive, such as management companies).

Question 29: Do you believe that there is need to promote further harmonisation of the supervision and cooperation by European regulators of depositary activities? What are your views on the creation of an EU passport for UCITS depositaries?

Most CESR members recommend imposing a harmonised requirement of reporting of breaches or irregularities by the UCITS management. In view of implementation of the management company passport, the new UCITS Directive requires detailed level 2 rules (organisational requirements, management of conflicts of interest, conduct of business rules etc) to be applied to management companies in order to create a robust, common basis of regulation for these entities across the EU. All CESR Members but one believe that, in view of the increasing cross-border dimension of UCITS management and marketing within the EU, it may be worth further harmonising depositary supervision or supervisory controls. If felt necessary, this could be done by issuing relevant level 2 measures and by complementing these with CESR guidelines at level 3.

The issue of an EU passport for UCITS depositaries is a much- and long-debated question. A few CESR Members consider that the creation of such a passport should be subject to a prior and strict condition: harmonising the status, the role and the liability regime of UCITS depositaries. As already mentioned, CESR emphasises that the EU management company passport is being made effective at the price of harmonised and detailed organisational requirements and conduct of business rules imposed to management companies.

UCITS depositary rules that must be harmonised prior to considering a passport include specific requirements regarding the UCITS depositary liability. For instance, the authority (Court or competent authority) which is entitled to sanction the failure of performance of duties by a UCITS depositary should also be harmonised.

However, a large majority of CESR Members take the view that there should be a strict requirement that the depositary is located[14] in the same Member State as the UCITS fund. They hold this view not least because of the recent introduction of a passport for UCITS management companies which is largely predicated on the requirement that a depositary and UCITS be located in the same Member State. In addition, this would avoid the UCITS becoming a virtual letter box entity.

Question 30: As far as the UCITS portfolio and UCITS units or shares are concerned, do you agree that their value should be assessed by an independent valuator?

[14] Some CESR Members also allow the depositary to be located in the same Member State by means of a branch.

Question 31: If so, what should be the applicable conditions for an entity to be eligible to act as an UCITS valuator?

CESR notes that such a proposal in the draft AIFM Directive seems relatively controversial. CESR does not feel that such a requirement for independent UCITS valuation would improve the level of investor protection. There are many unanswered questions regarding the entity that would be in charge of such an independent valuation: capital requirements; organisational rules; liability regime; independence; expertise; risk management; etc.

In application of a common sense principle that UCITS managers should only invest in assets they understand and can value, CESR considers that the management company has to be responsible for the valuation of the UCITS it manages. Entrusting the responsibility for UCITS valuation to another entity could lead to a situation where the management company is less accountable to its investors and clients.

6. Conclusion

The time is ripe for the clarifications and precisions regarding the status, role and liability regime of UCITS depositaries that the Commission already envisaged in its 2004 Communication.

Restoring UCITS investors' confidence in Europe and beyond European boundaries will allow the growth of the dynamic European asset management industry, but this requires a clear, certain and harmonised UCITS depositary framework. CESR remains at the disposal of the European institutions to launch this crucial improvement without any delay.

Annex 1 – Summary of CESR's mapping exercise of duties and liabilities of UCITS depositaries

1. Background

CESR conducted a survey on the rules which are applied at national level with respect to the liabilities and responsibilities of depositaries, including in the case of sub-custody of the UCITS' assets. 29 Members responded to the survey. The responses confirmed that CESR Members have implemented and interpreted the requirements of the UCITS Directive in relation to depositaries in divergent ways.

2. The depositary status

(i) Eligible institutions

Regarding which entities are eligible to act as depositaries of UCITS, rules differ across CESR Members. Whereas three-fifths of the respondents would only allow credit institutions to act as depositaries, some Members would allow other entities such as investment firms. One Member also allows insurance companies to act as such.

(ii) Location

As provided by the UCITS Directive, respondents require the depositary to have its registered office in their jurisdiction or to be established in their jurisdiction when the depositary is registered in another Member State. However, the requirement for "being established" is transposed differently across respondents. In most cases, the minimum requirement is to be a registered branch of a credit institution established in the jurisdiction.

(iii) Approval

Some Members require institutions to receive specific authorisation in order to act as depositaries.

In most Member States, the choice of the depositary must be approved by the CESR Member.

3. Depositary requirements

(i) Capital requirements

Of the 17 Members that require depositaries to be credit institutions, 12 also impose capital requirements. The amount of capital required ranges from 5 to 100 million euros.

Of the respondents that do not limit acting as a depositary to credit institutions, three Members require the entity to fulfil capital requirements.

(ii) Independence

Regarding the relationship between the depositary and the management company, some Members specified that they apply the Article 25(1) and/or 25(2)[15] of the UCITS Directive. The seven Members that provided details concerning their application of the Article require that no manager and

[15] Article 25(1): No company shall act as both management company and depositary

Article 25(2): In the context of their respective roles, the management company and the depositary shall act independently and solely in the interest of the unit-holders.

member of the custodian bank's board shall be a member of the board of the investment fund management company.

4. The depositary's duties

(i) General duties

Concerning the depositary duties, with the exception of safekeeping, most CESR Members base their requirements on Articles 22(3) and 32(3).

(ii) Definition of "safe-keeping" at the Member State level

Regarding the definition of safe-keeping, ten Members refer only to Article 22(1) of the UCITS Directive without elaborating further. Of the 12 Members that have specified their interpretation of safe-keeping, the majority consider it to involve performing custody and supervision of the assets.

(iii) Segregation of the assets

The CESR mapping has identified that 11 Members require a segregation of the assets, four of which specify that the fund's assets must be segregated from the depositary's assets in nominative accounts.

5. Case of sub-custody

(i) Delegation of functions

Regarding the functions that can be delegated, all Members but one (the latter allowing delegation of safe-keeping functions only in the case of foreign physical financial instruments) agree that the UCITS Directive implicitly permits a UCITS depositary to delegate its custody functions. In contrast, the mapping highlighted that all but four Members interpret the UCITS Directive as not permitting delegation of supervisory functions.

(ii) Requirements on the depositary in case of delegation

A majority of Members specify some level of standard of care that would be expected from a depositary that entrusts the safekeeping of assets to a sub-custodian. This standard of due diligence covers the selection and appointment of the sub-custodian so as to ensure that it has and maintains expertise and competence commensurate with its duties.

Some Members require the depositary to maintain an appropriate level of supervision over the safe-keeping third party and make appropriate inquiries from time to time to confirm that that the obligations of the sub-custodian continue to be adequately discharged.

Three Members specify that the depositary and the sub-custodian must enter into a written agreement detailing the conditions of the delegation.

Only two Members require that the appointment of the sub-custodian be subject to the competent authority's approval.

6. Liability regime of UCITS depositaries

(i) General

Concerning the liability regime of UCITS depositaries, all Members base their requirements on Article 24[16] of the new UCITS Directive. Five Members require the depositary to restore assets held in custody when any loss has occurred.

(ii) In case of sub-custody

Concerning the liability regime in case of sub-custody, the CESR mapping has shown some divergence in national practices. While one third of CESR Members impose an obligation of means[17], another third[18] of Members impose an obligation of result[19]. Seven Members do not make a distinction between an obligation of means and an obligation of result. For all CESR Members, the responsibility of the depositary is not affected in case of delegation.

For five Members, the effects of delegation arrangements on liability may also depend on contractual agreement.

In summary, a majority of Members consider that depositaries would be liable to restore assets and may seek repayment from the sub-custodian if the latter is responsible for the failure. However, some Members consider that a depositary should only be liable to restore assets if it is proven that it wrongfully failed to perform its obligations or performed them improperly, or if the depositary cannot demonstrate that it took reasonable care to ensure that assistance was provided to the sub-custodian in a competent manner.

[16] Article 24: A depositary shall, in accordance with the national law of the UCITS home Member state, be liable to the management company and the unit-holders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them.

[17] An 'obligation of means' should be understood as an obligation on the depositary to devote appropriate resources and carry out appropriate due diligence so as to ensure safe-keeping of assets. This would imply that:
(i) the depositary would be liable to investors only if it has failed to perform this obligation or has improperly performed it;
(ii) in case the safe-keeping function is delegated to a third party and a failure occurred at the level of the latter, the depositary would be liable to investors, and thus to restore assets or indemnify investors, only if it has failed to perform its obligation vis-à-vis the third party.

[18] Of these, one imposes no legal prohibition on the inclusion of contractual clauses aimed at limiting liability, although these are unlikely to be enforceable in the case of a serious breach of obligations.

[19] An 'obligation of result' should be understood as an obligation on the depositary to safe-keep assets. This would imply that:
(i) the depositary would therefore be liable to investors if assets have not been safe-kept (regardless of whether there is an unjustifiable failure or improper performance on the part of the depositary);
(ii) in case the safekeeping function is delegated to a third party and a failure occurred at the level of the latter, the depositary would be liable vis-à-vis the investors, and thus to restore assets to them.