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COVER NOTE

from: Mario DRAGHI, President of the European Central Bank
date of receipt: 17 January 2013
to: Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union
Subject: ECB opinion on a proposal for a DIRECTIVE OF THE EUROPEAN
PARLIAMENT AND OF THE COUNCIL amending Directive 2009/65/EC on
the coordination of laws, regulations and administrative provisions relating to
undertakings for collective investment in transferable securities (UCITS) as
regards depositary functions, remuneration policies and sanctions
(CON/2013/4)

Delegations will find attached the above mentioned opinion.

Encl.:

OPINION OF THE EUROPEAN CENTRAL BANK

of 11 January 2013

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

(CON/2013/4)

Introduction and legal basis

On 19 September the European Central Bank (ECB) received a request from the European Parliament for an opinion on a proposal for a directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions¹ (the ‘proposed directive’).

The ECB’s competence to deliver an opinion on the proposed directive is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union, since the proposed directive contains provisions affecting the European System of Central Banks’ contribution to the smooth conduct of policies by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system under Article 127(5) of the Treaty. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

General observations

The ECB broadly welcomes the proposed directive, which is aimed at strengthening the UCITS framework specifically with regard to: (i) remuneration policies and practices of senior management, risk takers and those who exercise control functions; (ii) the rules on the appointment of the depositaries for the UCITS funds and the performance of the depositary functions, including the related liability regime; and (iii) the regime for administrative sanctions and measures. The ECB considers that the new rules may play an important role in preventing malpractices and enhancing investor confidence. The ECB notes that the proposed strengthening of the UCITS framework is a timely measure given the enhancements already achieved in the regulation of alternative investment fund managers through Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010² (hereinafter the ‘AIFM Directive’).

¹ COM(2012) 350 final.

² OJ L 174, 1.7.2011, p. 1. See ECB Opinion CON/2009/81 of 16 November 2009 on a proposal for a directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC (OJ C 272, 13.11.2009, p. 1). All ECB opinions are published on the ECB’s website at www.ecb.europa.eu.

Specific observations

1. Reuse of assets by a UCITS depositary

The ECB considers that the proposed directive should explicitly prohibit a UCITS depositary or any party to whom the custody of a UCITS fund has been delegated from reusing the assets under its management for its own account. Such practices may put investors at risk, as well as trigger risks relevant from a financial stability perspective, due to the leverage arising from these practices. In this context, the ECB considers that the UCITS framework needs to be more stringent in this respect than the AIFM Directive, which allows reuse of assets conditional on the prior consent of a fund's managers. This is justified by the fact that UCITS products are widely distributed to retail investors, while funds managed under the AIFM Directive are generally reserved for professional investors.

2. Delegation

The proposed directive allows a depositary's safekeeping duties to be delegated to a sub-custodian under certain conditions that, according to the explanatory memorandum, are aligned with those applicable under the AIFM Directive. In this respect the ECB considers that protection of retail investors requires more stringent rules for UCITS depositaries than for depositaries appointed by alternative investment funds managers. In particular, the delegation by a UCITS depositary to a sub-custodian located outside the European Union should be subject in all cases to appropriate safeguards, such as minimum capital requirements and effective supervision in the country concerned. Finally, a review is also needed in regard to maintaining the exceptions allowing for entities in third countries to function as a sub-custodian of a UCITS depositary, despite such entities not satisfying the requirements for delegation laid down by the Union law.

3. Eligibility to act as a UCITS custodian

The ECB supports the introduction of eligibility conditions according to which only credit institutions and investment firms may act as UCITS depositaries. This will diminish the risk of investors being defrauded as a result of the appointment of a UCITS depositary that is not subject to an appropriate level of regulation and supervision. Moreover, it should be further assessed whether the proposed regime for capital requirements for credit institutions and investment firms¹ provides for adequate safeguards in relation to the exercise of the UCITS depositary functions, given the scale and complexity of the UCITS for which these functions are exercised and the liability risks that these functions generates.

4. Liability

¹ See proposal for a directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (COM(2011) 453 final), and proposal for a regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (COM(2011) 452 final).

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The ECB considers that the ‘external events beyond ... reasonable control’¹ which trigger the possibility for a depositary to discharge liability by contract should be specified in the Commission delegated acts in a detailed manner, referring to the categories of assets that may be considered lost due to such external events and the specific types of events envisaged.

Where the ECB recommends that the proposed directive is amended, specific drafting proposals are set out in the Annex accompanied by explanatory text to this effect.

Done at Frankfurt am Main, 11 January 2013.

The Vice-President of the ECB

Vitor Constâncio

¹ See Article 26b point (f) of Directive 2009/65/EC inserted by Article 1(8) of the proposed directive.

Drafting proposals

Text proposed by the Commission	Amendments proposed by the ECB ¹
<p style="text-align: center;">Amendment 1</p> <p style="text-align: center;">Article 1(3)</p>	
<p>‘(3) Article 22 is replaced by the following:</p> <p>“Article 22</p> <p>...</p> <p>5. The assets of the UCITS shall be entrusted to the depositary for safe-keeping as follows:</p> <p style="padding-left: 40px;">(a) ...</p> <p style="padding-left: 40px;">(b) ...</p> <p>...</p> <p>7. The depositary shall not delegate to third parties its functions as referred to in paragraphs 3 and 4.</p> <p>...</p> <p>The functions referred to in paragraph 5 may be delegated by the depositary only to a third party which at all time during the performance of the tasks delegated to it:</p> <p style="padding-left: 40px;">(a) has structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the UCITS or the management</p>	<p>‘Article 22 is replaced by the following:</p> <p>“Article 22</p> <p>...</p> <p>5. The assets of the UCITS shall be entrusted to the depositary for safe-keeping as follows:</p> <p style="padding-left: 40px;">(a) ...</p> <p style="padding-left: 40px;">(b) ...</p> <p>5a. Financial instruments and other assets held in custody shall not be reused by way of encumbrance or transfer made on its own account by the depositary or any party to whom the custody function has been delegated, under penalty of invalidating the contractual provisions allowing for the reuse.</p> <p>...</p> <p>7. The depositary shall not delegate to third parties its functions as referred to in paragraphs 3 and 4.</p> <p>...</p> <p>The functions referred to in paragraph 5 may be delegated by the depositary only to a third party which at all time during the performance of the tasks delegated to it:</p> <p style="padding-left: 40px;">(a) has structures and expertise that are adequate and proportionate to the nature and complexity of the assets of</p>

¹ Bold in the body of the text indicates where the ECB proposes inserting new text. Strikethrough in the body of the text indicates where the ECB proposes deleting text.

Text proposed by the Commission	Amendments proposed by the ECB ¹
<p>company acting on behalf of the UCITS which have been entrusted to it;</p> <p>(b) for custody tasks referred to in point (a) of paragraph 5, is subject to effective prudential regulation, including minimum capital requirements, and supervision in the jurisdiction concerned;</p> <p>...</p> <p>Notwithstanding point (b) of the third subparagraph where the law of a third country requires that certain financial instruments be held in custody by a local entity and no local entities satisfy the delegation requirements laid down in that point, the depositary may delegate its functions to such a local entity only to the extent required by the law of the third country and only for as long as there are no local entities that satisfy the delegation requirements, and only where:</p> <p>(a) the investors of the relevant UCITS are duly informed that such delegation is required due to legal constraints in the law of the third country and of the circumstances justifying the delegation, prior to their investment;</p> <p>(b) the UCITS, or the management company on behalf of the UCITS, have instructed the depositary to delegate the custody of such</p>	<p>the UCITS or the management company acting on behalf of the UCITS which have been entrusted to it;</p> <p>(b) for custody tasks referred to in point (a) of paragraph 5, is subject to effective prudential regulation, including minimum capital requirements, and supervision in the jurisdiction concerned;</p> <p>...</p> <p>Notwithstanding point (b) of the third subparagraph where the law of a third country requires that certain financial instruments be held in custody by a local entity and no local entities satisfy the delegation requirements laid down in that point, the depositary may delegate its functions to such a local entity only to the extent required by the law of the third country and only for as long as there are no local entities that satisfy the delegation requirements, and only where:</p> <p>(a) the investors of the relevant UCITS are duly informed that such delegation, which does not fully satisfy the general delegation requirements laid down by Union law, is required due to legal constraints in the law of the third country and of the circumstances justifying the delegation, prior to their investment;</p>

Text proposed by the Commission	Amendments proposed by the ECB ¹
<p>financial instruments to such a local entity</p> <p>...” ’</p>	<p>(b) the UCITS, or the management company on behalf of the UCITS, have instructed the depositary to delegate the custody of such financial instruments to such a local entity.</p> <p>...” ’</p>
<p style="text-align: center;"><u>Explanation</u></p> <p><i>The ECB considers that the UCITS framework needs to be more stringent than the framework foreseen in the AIFM Directive in that it should not allow reuse of assets by the depositary under any conditions. This is justified since: (i) UCITS products are widely distributed to retail investors; and (ii) the reuse of assets by the depositary may trigger risks relevant from a financial stability perspective, due to the leverage arising from these practice.</i></p> <p><i>The delegation by a UCITS depositary to a sub-custodian located outside the Union should optimally be subject to the same safeguards, such as minimum capital requirements and effective supervision in the country concerned, as required by Union law. Where exemptions apply, they should be clearly communicated to an investor. In this respect, the protection of retail investors requires more stringent rules for UCITS depositaries than depositaries appointed by alternative investment funds managers.</i></p>	
<p style="text-align: center;">Amendment 2</p> <p style="text-align: center;">Article 1(8)</p>	
<p>‘(8) The following Articles 26a and 26b are inserted:</p> <p>“Article 26a</p> <p>...</p> <p>Article 26b</p> <p>1. The Commission shall be empowered to adopt, by means of delegated acts in accordance with Article 112 and subject to the conditions of Articles 112a and 112b, measures specifying:</p>	<p>‘(8) The following Articles 26a and 26b are inserted:</p> <p>“Article 26a</p> <p>...</p> <p>Article 26b</p> <p>1. The Commission shall be empowered to adopt, by means of delegated acts in accordance with Article 112 and subject to the conditions of Articles 112a and 112b, measures specifying:</p>

Text proposed by the Commission	Amendments proposed by the ECB ¹
<p>...</p> <p>(f) what is to be understood by external events beyond reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary pursuant to Article 24(1).”</p> <p>,</p>	<p>...</p> <p>(f) what is to be understood external events beyond reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary pursuant to Article 24(1),</p> <p>including specific types of such events and the categories of assets that may be considered lost due to such external events.”</p> <p>,</p>
<p style="text-align: center;"><u>Explanation</u></p> <p><i>The ‘external events beyond ... reasonable control’ which trigger the possibility for the depositary to discharge liability by contract should be specified in the Commission delegated acts in a detailed manner referring to the categories of assets that may be considered lost due to such external events and the specific types of such events envisaged.</i></p>	