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COVER NOTE

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to:	Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union
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Subject:	COMMISSION STAFF WORKING DOCUMENT EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT Accompanying the document 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

Delegations will find attached Commission document SWD(2012) 186 final.

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COMMISSION STAFF WORKING DOCUMENT

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

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

{COM(2012) 350 final}
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1. PROBLEM DEFINITION

The problem

European rules on depositaries that act on behalf of collective investment schemes, contained in the Directive on undertaking for the collective investment in transferable securities ("UCITS"), have remained unchanged since their introduction in 1985. The financial crisis, notably the Madoff affair that came to light on 11 December 2008, has exposed weaknesses in the UCITS rules on the duties and liability of depositaries.

The Madoff case raised in particular the issue of the liability of a depositary where custody of a UCITS fund's assets is delegated to a sub-custodian. In the Madoff case, national courts in different Member States took different approaches when deciding whether the principal custodian of a UCITS fund was liable for the return of fund assets that were lost while held in sub-custody.

In addition, the harmonised UCITS framework lacks general principles on remuneration and on sanctions consistent with other areas of the financial services.

Who is most affected?

The investment fund industry is a vital part of the EU financial sector. The success of UCITS as a cross-border vehicle for investments is borne out by the rapid growth of assets managed in UCITS funds. Total assets under management (AuM) grew from €3,403bn at the end of 2001 to €5,889bn by 2010. In September 2011 AuM stood at €5,515bn. This development is in part due to the UCITS Directive's harmonized rules on collective investment schemes that establish a European capital market for the free circulation of investment fund products that comply with the UCITS standard. The evolution of the UCITS rules is therefore important for the development of an integrated market that allows the cross-border sales of UCITS.

The target group most affected when assets held in custody are lost are retail investors. If the principal custodian is not liable for the return of assets lost in custody, the loss is borne by investors. On average, 10% of European households invest directly in funds: Germany (16%), Italy (11%), Austria (11%), France (10%), Spain (7%), United Kingdom (6%).

Another group affected by the loss of assets is the manager of a UCITS fund. The fund manager needs clarity as to the scope of a depositary's liability for the loss of custodial assets, especially when this loss occurs while the assets are held in custody at a sub-custodian. Sub-custody is an increasingly wide-spread phenomenon as UCITS managers invest in a wide range of financial instruments (stock, bonds, debt instruments, money market instruments, shares or units in other invest funds, etc.) that are often issued in other Member States or third countries. For practical reasons and sometimes on account of legal requirements, these instruments have to be kept in custody in the country where they are issued. Sub-custody has therefore important implications for a fund manager's investment decisions.

Finally, depositaries and their delegation practices will be affected. Even large global custodians do not have custody operations of their own across all of the jurisdictions in which a UCITS manager might seek to invest. No single custody bank is believed to have operations in more than 40 jurisdictions. Custody is often "outsourced" therefore to sub-custodians operating in jurisdictions not covered by a global custodian's network. The conditions that govern such delegation are core issues affecting depositaries.

2. ANALYSIS OF SUBSIDIARITY

Necessity

National approaches on the issue of the duties and liability of depositaries, especially where safekeeping is delegated, have created an uneven level of consumer protection, as made particularly evident following the Madoff case.

In particular, national rules diverge on the conditions applying where safekeeping is delegated. In addition, differences exist over the on-going duties of a depositary to monitor sub-custodians and, most importantly, the liability of the depositary for loss of assets held in sub-custody. While some national courts oblige the depositary to return instruments lost in sub-custody, others make this obligation contingent on a failure to perform due diligence and oversight duties.

Added value

Differences in the implementation of high-level principles within the UCITS Directive on delegation, and in particular on the liability of depositaries, undermine investor confidence, especially where UCITS are sold cross-border. Only action at European level can address this issue effectively and introduce harmonised standards, both in relation to a depositary's duty of care in selecting and overseeing a sub-custodian and in relation to its liability for assets lost in custody.

3. OBJECTIVES OF EU INITIATIVE

Existing 'high level' UCITS rules allow for considerable inconsistencies amongst national authorities in interpreting duties of care and liability in case of their breach. More detailed rules on delegation and liability are necessary to reduce such inconsistencies. This concerns in particular: (1) the permitted scope of delegations; (2) the conditions covering delegations; and (3) the system of liability that applies when instruments in custody are lost, either at depositary level or at the level of the sub-custodian.

General objective

Increase protection and transparency for all UCITS investors.

Specific objectives

Standards of investor protection should be uniform: depositaries, subject to consistent prudential and capital requirements, should ensure the same level of protection of assets in custody, independent of their domicile.

Redress against depositaries for loss of a financial instrument should be consistent and effective: uniform standards of care and uniform rules on liability should avoid lengthy litigation and inconsistencies in outcomes depending on the domicile of the depositary.

Legal certainty in relation to depositaries' duties in respect of safekeeping and delegation: allow the industry to adapt to a uniform standard and make the necessary arrangements in their organisational structures/business models.

Operational objectives

These are to:

(1) harmonise criteria on eligibility to act as depositary;

(2) introduce a uniform rules on delegation of safekeeping;

(3) introduce a uniform level of depositaries' liability for the return of an instrument lost in the course of custody; and

(4) introduce a uniform level of liability for cases when the loss occurs at the level of the sub-custodian.

In line with the objective of enhancing investor confidence and transparency, the other operational objectives related to remuneration and sanctions are: introducing rules to ensure remuneration does not contribute to risks, by ensuring remuneration practices are transparent and sound; and introducing a uniform UCITS sanctioning regime.

4. POLICY OPTIONS

The baseline scenario relating to the tasks and liability of depositaries is the existing UCITS framework. The general principles of the UCITS rules would remain in place, leaving significant discretion on the level of duties and liability to national authorities, who would be responsible for ensuring investor protection and confidence, especially when making cross-border investments with funds domiciled in other Member States.

Against this baseline, the impact assessment assesses different options in relation to three core issues: (1) eligibility to become a UCITS depositary; (2) the conditions that apply in case safekeeping is delegated; and (3) the scope of a depositary's liability, in particular the obligation to return financial instruments that are lost in custody.

On eligibility to act as a depositary, three options emerged, identifying different institutions that are deemed to provide sufficient guarantees in terms of prudential regulation and capital requirements to fulfil the task of safekeeping assets and ensuring their return in case of a custodial loss.

On the issue of delegation of custody, three options were assessed: (1) the baseline; (2) introducing diligence and prudential requirements to cover delegations, including special rules on delegations to non-compliant third country custodians and (3) introducing the same diligence and prudential requirements for all delegations.

On the issue of liability, the impact assessment examined four options: (1) limiting liability to 'unjustifiable failures to act' (the baseline); (2) introducing strict liability with an option to discharge liability in case of delegations; (3) introducing strict liability with the discharge option limited to mandatory delegation to third country custodians; and (4) introducing strict liability with no option of discharge in case of delegations.

In relation to remuneration, the baseline was compared with an option requiring UCITS management companies to have general principles on remuneration in place and an option required detailed remuneration policies coupled with disclosure of actual remunerations paid in the annual report.

In relation to administrative sanctions, the baseline was compared to an approach harmonising sanctions in a general manner, as set out in Commission policies in this area, and an option of further harmonisation of administrative sanctions.

5. ASSESSMENT OF IMPACTS

On eligibility to act as a depositary, the impact assessment concludes that both credit institutions and regulated investment firms provide sufficient guarantees in terms of prudential regulation, capital requirements and effective supervision to act as UCITS depositaries. As most UCITS depositaries in almost all Member States are already credit institutions or regulated investment firms, the burden of adapting is estimated to be rather low. The impact of the chosen option would thus only concern a small minority of unlicensed service providers. In these cases, the cost of seeking a license as an investment firm appears justifiable given the benefits in case of depositary liabilities.

On delegations, the impact assessment concludes that delegations should be subject to high quality standards in terms of selection and on-going monitoring of the sub-custodian. These duties should be incumbent on the principal custodian. In terms of third countries, delegations should be allowed to non-compliant custodians, so long as local custody is mandated by law and so long as investors are duly informed that investments in certain jurisdictions may require local custody. The option of not allowing third party delegations to non-compliant custodians was discarded as this would reduce the investment opportunities available to UCITS funds. Furthermore, the risk of delegation to non-compliant third party custodians was considered negligible given the current preponderance of conservative investment strategies pursued by UCITS funds. As and if investment strategies evolve, this choice may need to be reviewed.

With respect to liability, the impact assessment concludes that a 'strict liability' standard obliging depositaries to return instruments lost in custody irrespective of fault or negligence is both conducive to ensuring a high level of investor protection and to achieving a uniform standard across the EU. While there are strong arguments to 'carve out' losses that arise in case of a mandatory delegation to a third country custodian, the impact assessment concludes that, in light of the retail orientation of UCITS funds, that there should be no such 'carve out'.

6. SUMMARY OF RETAINED OPTIONS

The preferred option is to limit eligibility to become a UCITS depositary to either a credit institution or a regulated investment firm. Delegations should be governed by rules on due diligence in selecting, appointing and monitoring the activities of the sub-custodian. For the rare case in which a UCITS' investment strategy would involve investing in financial instruments issued in countries that require mandatory local custody and where no custodian operates that could comply with the above delegation requirements, delegation should be allowed under strict circumstances.

In line with the retail investor profile, liability in case of the loss of an instrument held in custody should be based on a uniform EU standard entailing an obligation to return the lost instrument at the cost of the principal custodian. There should be no option for the principal custodian to discharge liability, even in cases where local custody is mandatory in a third country.

In relation to remuneration, the approach follows that taken with respect to AIF managers. This avoids regulatory arbitrage between the UCITS and the AIFMD frameworks. On sanctions general Commission policy in this area is followed.

7. MONITORING AND EVALUATION

Monitoring and evaluation will take place on two levels. First, the Commission will ensure that the reformed rules are implemented correctly. In a second phase, three years after the deadline of full implementation for the Directive, the Commission will proceed to conduct an economic evaluation of whether the new rules have increased investor protection, enhanced transparency on remuneration and have fostered investor confidence necessary for the continued relevance of the UCITS retail brand.

The economic evaluation shall be performed on the basis of the objectives identified in section 3.

The evaluation shall be carried out by the Commission's services, in cooperation with ESMA and/or with the aid of external studies as may be necessary to assess the impact of changes to delegation and liability schemes for depositaries.

For the purpose of evaluating the effects of the amendments and, more importantly, of gathering essential data on the impact of some of the proposed measures on the depositary industry, further fact-finding with all relevant stakeholders is likely.

The review shall concentrate its attention, in particular, on the extent to which expected cost savings deriving from a clearer and harmonised liability regime for depositaries are realised; possible impacts of new delegation and liability rules may have on depositary’s operating costs; an assessment of the extent to which delegations to non-compliant third country depositaries have occurred and the impact of these; and an estimate of the impact of any incremental operating costs on UCITS fund costs and returns for investors.