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Delegations will find attached document SWD(2015) 293 final.

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**COMMISSION STAFF WORKING DOCUMENT**

**IMPACT ASSESSMENT**

*Accompanying the document*

**COMMISSION DELEGATED REGULATION**

**supplementing Directive 2009/65/EC of the European Parliament and of the Council  
with regard to obligations of depositaries**

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## 1. INTRODUCTION<sup>1</sup>

The financial crisis, and in particular the Madoff events, have put the spotlight on the duties and the liability of the investment funds depositaries.

In order to address these issues, the European Commission, in July 2012, presented a proposal to amend the Undertakings for Collective Investments in Transferable Securities (UCITS) Directive. Following the adoption in co-decision, UCITS V<sup>2</sup> Directive was published in the Official Journal of the European Union on 28 August 2014 and came into force on 17 September 2014. Member States must adopt and publish the laws and regulations necessary to comply with the UCITS V Directive by 18 March 2016. The UCITS V Directive amends and replaces certain provisions of Directive 2009/65/EC (UCITS IV)<sup>3</sup> therefore all references to the amended provision will be further refereed as to UCITS.

The UCITS V Directive mirrors, to a large extent, the provisions on depositaries that were introduced in the Alternative Investment Fund Managers Directive<sup>4</sup> (AIFMD), which were further implemented through a Delegated Regulation 231/2013<sup>5</sup>.

This impact assessment focuses on two empowerments contained in the UCITS V Directive that are not part of the existing rules on fund depositaries contained in the AIFM Delegated Regulation, which are: (1) the insolvency protection of UCITS assets when the depositary delegates safekeeping duties to a third party (Article 26b (e) UCITS) and (2) the requirement that the UCITS management/investment company and the UCITS depositary act independently (Article 26b (h) UCITS).

### 1.1 The UCITS Directive

UCITS V new depositary requirements are meant to broadly align the UCITS Directive with the AIFM Directive in terms of rules on depositaries' duties, delegation arrangements, and the liability regime for custodial assets. These rules aim at addressing non-market risks related to the depositaries activities. As a consequence, the empowerments for the Commission to adopt delegated acts on depositaries under UCITS V, with the exception of the two empowerments mentioned above, are identical to the ones that were foreseen by the AIFM Directive. The European Securities and Markets Authority (ESMA) provided its technical advice on these empowerments in 2011<sup>6</sup>.

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<sup>1</sup> In producing this impact assessment, data has been collected from a variety of different sources. Therefore all conclusions drawn should be treated with an appropriate degree of caution.

<sup>2</sup> Directive 2014/91/EU

<sup>3</sup> Directive 2009/65/EC

<sup>4</sup> Directive 2011/61/EU

<sup>5</sup> Commission Delegated Regulation (EU) No 231/2013

<sup>6</sup> [http://www.esma.europa.eu/system/files/2011\\_379.pdf](http://www.esma.europa.eu/system/files/2011_379.pdf)

## 1.2 UCITS investment funds and management companies

All investment funds in the EU fall into one of the following two categories: undertakings for collective investment in transferable securities (UCITS) or alternative investment funds (AIFs). UCITS funds are those that comply with harmonised rules (in particular product rules) as laid down in the UCITS Directive thereby permitting their sale to the retail investors. AIFs are all investment funds other than UCITS and their managers are required to comply with rules laid down in the AIFM Directive. The latter are not subject to this impact assessment.

Institutional investors represent the largest client category of the European asset management industry – they account for 76% of total assets under management ("AuM") in Europe<sup>7</sup>. To note: the institutional investor base for UCITS does not only comprise the usual institutional client base (banks, treasurers or corporates) but includes pension funds and insurance companies. Retail investors represent 24 % of total UCITS assets under management in Europe.

UCITS funds have been successful within Europe as well as in Asia and South America, resulting in a steady rise in UCITS assets under management over the years: from €5,694 billion as of the end of 2010<sup>8</sup> to €6,455 billion as of the end of 2013<sup>9</sup> to €7,514 billion as of the end of 2014<sup>10</sup>. Annex 3 provides additional information in the UCITS sectors especially the breakdown of UCITS investment asset classes and geographical allocation of funds.

## 1.3 UCITS depositaries

The UCITS Directive requires each UCITS to appoint a depositary which is entrusted with a duty of safekeeping compassing: controlling of the title of any assets received by the fund and keeping assets in custody or, where this is not possible, keeping records of ownership. UCITS depositaries also monitor cash flows and exercise additional oversight functions described below. The largest UCITS depositaries are large international banks<sup>11</sup> or their subsidiaries. Depositaries provide custody (safekeeping) services<sup>12</sup> to investment funds (UCITS and AIFs) but also to other investors, e.g. pension funds, insurance companies, or individual investors. Depositaries also provide additional (ancillary) services such as securities lending, brokerage and execution of foreign exchange trades.

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<sup>7</sup> EFAMA: Asset Management in Europe, Facts and Figures, December 2014

<sup>8</sup>Source (without taking into account AuM in Lichtenstein, Norway, Switzerland and Turkey): <http://www.efama.org/Publications/Statistics/Quarterly/Quarterly%20Statistical%20Reports/Quarterly%20Statistical%20Report%20Q4%202011.pdf>

<sup>9</sup> Net sales of UCITS reached €437 billion in 2014 and €221 billion in 2013. Demand for UCITS reached its highest level since 2006 and surpassed the net sales of €191 billion registered in 2012 (source EFAMA-[http://www.efama.org/Publications/Statistics/Quarterly/Quarterly%20Statistical%20Reports/150311\\_Quarterly%20Statistical%20Release%20Q4%202014.pdf](http://www.efama.org/Publications/Statistics/Quarterly/Quarterly%20Statistical%20Reports/150311_Quarterly%20Statistical%20Release%20Q4%202014.pdf) (without taking into account AuM in Lichtenstein, Norway, Switzerland and Turkey).

<sup>10</sup> Source: EFAMA INVESTMENT FUND INDUSTRY FACT SHEET, December 2013 and December 2014 Data (without taking into account AuM in Lichtenstein, Norway, Switzerland and Turkey).

<sup>11</sup> While the largest depositaries are typically banks, other types of institutions (e.g. Mifid firms) also exist in some Member States.

<sup>12</sup> The custody service would also include additional services such as clearing and settlement.

From a UCITS depositary perspective, keeping custody<sup>13</sup> of the fund's assets is one integral part of their overall function. However, the notion of "depositary" is wider than the notion of pure "custodian", in that the UCITS Directive requires a depositary to exercise specific oversight functions<sup>14</sup>, such as:

- Monitoring compliance with the UCITS rules and fund's investment limits;
- Monitoring cash flows, i.e. ensuring that investor money and cash belonging to the UCITS is booked correctly in the fund's accounts (cash reconciliation);
- Reconciling the depositary's holding register with the one provided by the fund administrator (holding reconciliation);
- Ensuring that the net asset value (NAV) of the UCITS is calculated in accordance with applicable rules;
- Ensuring that the sale, issue, repurchase, redemption and cancellation of shares of the UCITS takes place in accordance with national laws and the fund's rules.

Unlike safekeeping, the above functions cannot be delegated by the UCITS depositary to a third party; therefore some refer to these as the "core" depositary functions.

While custody originated with physical safekeeping of securities that existed only in paper form, custody nowadays comprises the processing and reconciling customers' securities holdings and transactions involving these securities. Modern custody is computer-based and requires large investments in information technology.

In addition, the custodian is often the only entity that can ensure the link between the central securities depositary (CSD) and a UCITS. This is because a UCITS is not eligible to become a member of the CSD. For most securities listed in regulated markets CSDs perform so-called 'notary function' by keeping a central register of a particular issue of securities for the purpose of enabling the settlement of transaction. Often the CSDs will only accept members that are regulated, financially sound, have robust operational capabilities, and have the ability to continuously invest in technology that ensures "straight-through" processing. Membership criteria, stipulated to minimise disruption to the functioning of a CSD, are a key driver for the investments a custodian has to expend in maintaining its information technology.

Depositary services are nowadays primarily offered by banks and occasionally by brokers. These providers have developed specialised services that cater to different customer segments. Section 1.4 of this impact assessment will identify the main providers of UCITS custody services in greater detail.

As a depositary can provide a variety of services (See annex 4), clients are generally charged on a per segment basis. This entails a fee for custody, transaction fees or depositary fees (fees related to the oversight function, the "supervisory" fees). In addition, a depositary who

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<sup>13</sup> Custody has its roots in physical safekeeping. In the era when securities existed only in paper form, investors needed a safe place to store the certificates that represented their ownership of a security. The immobilisation or dematerialisation of physical securities resulted in development of central securities depositaries (CSDs). CSDs maintain accounts for the participating banks or intermediaries (custodians), to whose accounts the relevant number of securities is credited. These intermediaries maintain accounts for the client- investors and for the client-intermediaries. The actual length of such a holding chain of intermediaries depends on the circumstances that prevail in the relevant jurisdictions.

<sup>14</sup> See Annex 4 – Depositary's function.

provides other services to a UCITS fund, such as fund accounting, fund administration, transfer agency, or foreign exchange management, will charge separate fees for these services.

According to data submitted to the European Commission's services custody fees (calculated in basis points) are significantly lower than the fees a depositary charges for its depositary services or the transactions fees. As a rough guide, custody fees are a fraction of depositary fees while depositary fees are a fraction of transaction fees.

It results that the provision of custody can only thrive on the basis of economies of scale and scope.

Taking into account the above considerations, this impact assessment will also analyse potential risk of concentration that could result from certain regulatory requirements of these delegated acts.

According to the data collected from Morningstar, 271 depositaries are active in the UCITS market in Europe. The list provided in Annex 5 classifies the 50 largest depositaries according to assets held in custody. Many of the larger depositaries are active in different Member States, often establishing local subsidiaries. All subsidiaries belonging to the same group have been consolidated to express the figures per group and at a European level. For example J.P. Morgan, including various subsidiaries, has €794 billion under custody spread over seven different Member States<sup>15</sup>. Smaller depositaries, on the other hand, tend to focus on one national market.

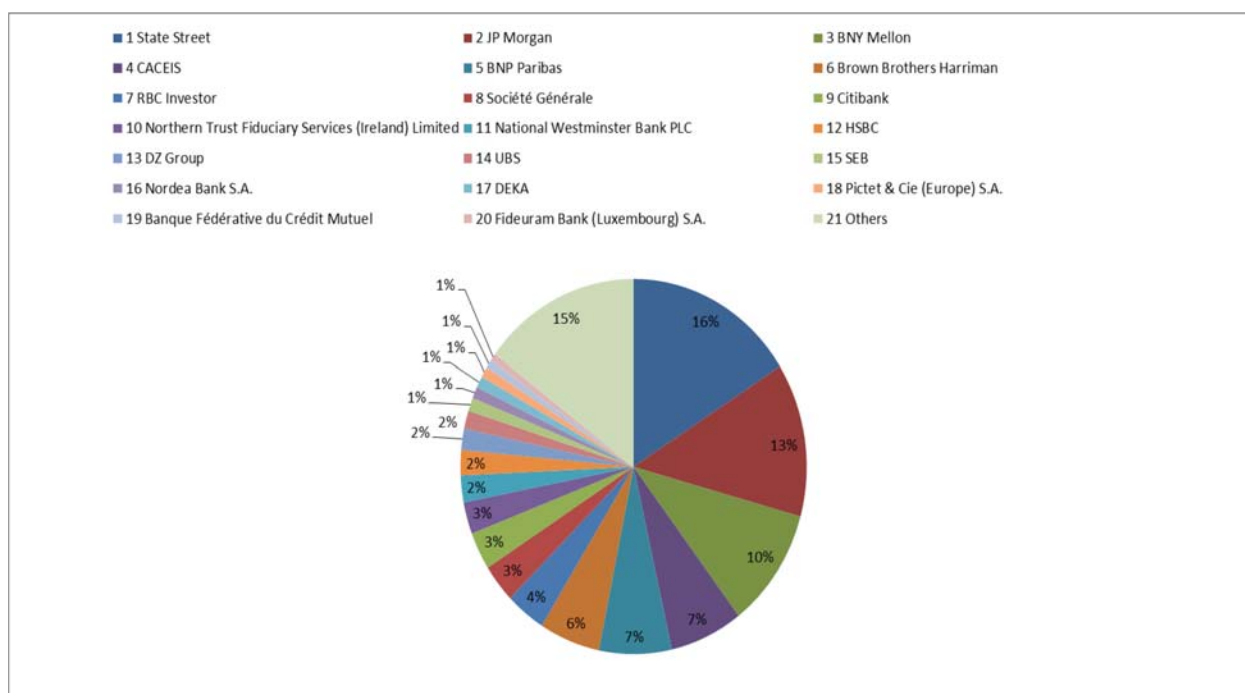
As mentioned in Annex 5, the degree of concentration in the UCITS depositary market varies between national markets. This impact assessment considers the geographic market for custody services nationally because (1) securities that are held in custody are issued nationally and (2) depositaries have to be located in the same Member State as the UCITS fund.

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<sup>15</sup> Source Morningstar as of 31 December 2014.



**Chart 1: Market share (in term of assets hold in custody) by the 20 largest depositaries for UCITS at the EU level**



Source: Morningstar, EC staff calculations as of December 2014

The top five depositaries in the major fund domiciles usually comprise the same providers (State Street Bank, J.P. Morgan, Bank of New York Mellon, CACEIS Bank and BNP Paribas Securities Services). The predominance of the same providers in all major markets, as well as their global coverage, is an indicator that economies of scale result when a network of custody spans several national markets. In addition, the predominance of these five players can be explained by the entry barriers that characterise custody services: strict liability for the loss of financial instruments, capital requirements and the need to establish electronic custody networks.<sup>16</sup>

#### 1.4 The link between the fund manager and the depositary

The UCITS management company is responsible for appointing a depositary for each fund in its portfolio. To be eligible, the depositaries must comply with all the requirements set out in the UCITS Directive. Depositaries need to be established in the same country as the UCITS fund. The UCITS rules do not prevent the fund manager to appoint a depositary that belongs to the same corporate group. Table 6 in Annex 5 contains a non-exhaustive list of examples of asset managers that appointed a depositary that belongs to the same corporate group.

Table 6 in Annex 5 reveals that asset managers that belong to a banking group tend to place a high percentage of their assets in custody with the depositary that belongs to the same banking group.

Asset managers that do not belong to a banking group must place assets in custody with a depositary outside the group. For example Blackrock, which is not a bank, manages approximately €220 bn of UCITS assets in Europe. These assets are placed in custody with

<sup>16</sup> See Annex 5

JP Morgan in Ireland (€62 bn), with Bank of New York Mellon in the United Kingdom and Luxembourg (€146 bn) as well as with State Street (€12bn). Aberdeen, which is managing UCITS assets in France, Luxembourg, the United Kingdom and Ireland, has appointed BNP Paribas Securities Services and State Street to safe-keep € 53 bn and € 36 bn of assets respectively. These figures show that asset managers that do not form part of a banking group entrust custody to the big internationally focused depositaries that are all ranked as part of the "top 5" in the depositary rankings reproduced in Annex 5.

Indeed most asset managers favor internationally focused depositary service providers because of their global custody network. This is due to the fact that management/investment companies not only invest in their national market, but also in the EU Members States and outside the EU. Another reason is that UCITS management/investment companies manage several UCITS that are not domiciled in the same Member State. For example, a French management company can manage a UCITS domiciled in Luxembourg without having an office in Luxembourg. In consequence, when a management company will select a depositary, coverage of all relevant fund domiciles will be an important criterion in selecting the depositary (which has to establish a branch in each fund jurisdiction) and thus avoiding appointing different depositaries in each Member State.

For example, only the top nine depositaries listed in Annex 5 have a geographic coverage ranging from 3 to 9 Member States; all other operators are confined to the territory of one, at maximum two, Member States.

***Table 1- Custody network of the top nine custodians***<sup>17</sup>

<b>Ranking</b>	<b>Custodian</b>	<b>AuM (in Mio EURO)</b>	<b>Country coverage</b>
<b>1</b>	<b>State Street Bank</b>	<b>959,361</b>	<b>9</b>
<b>2</b>	<b>JPM</b>	<b>794,321</b>	<b>7</b>
<b>3</b>	<b>Bank of New York Mellon</b>	<b>620,228</b>	<b>5</b>
<b>4</b>	<b>CACEIS Bank</b>	<b>408,888</b>	<b>4</b>
<b>5</b>	<b>BNP Paribas Securities Services</b>	<b>405,431</b>	<b>9</b>
6	BBH	340,189	3
7	RBC	223,485	6
8	Société Générale	198,674	6
9	Citi	195,357	3

*Source: Morningstar, Commission's own calculation as of December 2014.*

By entrusting custody to the "big nine" operators, the asset manager has a higher level of assurance that, irrespective of the place of investment, the chosen depositary will be able to delegate custody to a network of sub-custodians that belong to the same group. This allows maintaining certain business standards and a high level of protection against asset losses that could result from operational failures. Moreover, due to the considerable economies of scale that derive from operating a global network, custody rates may be negotiated at a lower level

<sup>17</sup> See Annex 5 for more details figures.

when compared to those charged by specialist operators whose lack of a custody network obliges them to work with third-party delegates.

## **2 PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES**

### **2.1 Procedural issues**

The UCITS Directive does not contain specific deadlines for the delivery of delegated acts concerning depositaries, it is however good practice to adopt implementing legislation sufficiently in advance before the end of the transition period in March 2016, in order to allow sufficient time for transposition and implementation by Member States and the relevant sector.

On 26 June 2014, the European Commission sent a request for technical advice on the level 2 measures in the UCITS Directive to ESMA. ESMA transmitted its technical advice to the European Commission on 28 November 2014.<sup>18</sup>

### **2.2 External expertise and consultation of interested parties**

Throughout the process of drafting its advice, ESMA was in close contact with the relevant sector, through bilateral meetings, a stakeholder roundtable and a formal public consultation.

The first written consultations on ESMA's advice covering in particular depositary rules took place on during the preparation of the delegated regulation resulting from the AIFM Directive. ESMA organised three open hearings covering the Call for Evidence and the two parts of the draft technical advice, the first in January and the second two in September 2011. Summaries of these hearings as prepared by ESMA are attached to the impact assessment report regarding Delegated Regulation 231/2013. Furthermore, ESMA organised a series of targeted workshops on the different parts of the AIFM Directive technical advice between March and May 2011. These workshops were not open to the public but only upon invitation. They brought together some fifteen to twenty industry experts on the respective subjects as selected by ESMA.<sup>19</sup>

The second written consultation on ESMA's advice took place in September 2014 specifically on the two empowerments contained in the UCITS V that were not part of the AIFM Directive<sup>20</sup>.

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<sup>18</sup> <http://www.esma.europa.eu/system/files/2014-1417.pdf>

<sup>19</sup> As it was the case in earlier consultations and hearings on asset management organised by the European Commission or ESMA in previous years, it was primarily the 'supply side', i.e. fund managers and, in parts, depositaries, that participated. The few responses from the 'buy side', i.e. investors, came from big players in the market like pension funds. Smaller and mid-size investors were represented through the Stakeholder Groups of ESMA which responded to the consultations or hearings. These representatives took also potential adverse impacts on retail investors into account but did not voice any major concerns.

<sup>20</sup> The summary consultation is provided in Annex 12

In addition to its written consultations ESMA organised a roundtable in order to gather comments from market participants on 29 July 2014. ESMA has invited experts from among UCITS managers, depositaries, prime brokers and consumer representatives.

***Table 2- ESMA consultations***

<i>Consultation</i>	<i>Consultation period</i>	<i>Number of responses</i>
Call for evidence on the European Commission's request for advice on AIFMD level 2 measures	3 December 2010 – 14 January 2011	51
Draft technical advice on AIFMD level 2 measures <sup>21</sup>	13 July – 13 September 2011	around 100
Draft technical advice on UCITS V level 2 measures <sup>22</sup>	26 September – 24 October 2014	60

## 2.3 Consultation with the Member States

On 23 April 2015, the Commission services consulted the Member States in the expert group of the European Securities Committee. The Commission's consultation focused on the two main issues to be resolved in the Level 2 measures, independent action and the safeguards that apply when a UCITS depositary delegates custody of UCITS assets to a third party.

*Topic 1: Independent boards and independent board members.*

With respect to the requirement that group entities should have at least two or one-third of board members that are not affiliated to the group, the following concerns have been raised by Members States:

- One Member State argues that the definition of independent board members was too strict. The Commission's services respond that a personal link (spouse on the group board) or a contractual link (consulting contract) would result in a presumption of conflicts of interest which it would be incumbent on the persons involved to rebut.
- One Member State argues that employee board members should only be required to have no personal or contractual links with the group if they have an executive function

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<sup>21</sup> The consultation documents and the responses that were cleared for publication can be found at the ESMA website: <http://www.esma.europa.eu/page/AIFMD>; summaries prepared by ESMA can be found in Annex 14 of the impact assessment report accompanying AIFMD Level 2 measures: [http://ec.europa.eu/internal\\_market/investment/docs/20121219-directive/ia\\_en.pdf](http://ec.europa.eu/internal_market/investment/docs/20121219-directive/ia_en.pdf).

<sup>22</sup> The consultation documents and the responses that were cleared for publication can be found at the ESMA website: <http://www.esma.europa.eu/consultation/Consultation-delegated-acts-required-UCITS-V-Directive> ; summaries can be found in Annex 12 of this impact assessment

within the group. The Commission services respond that employees that are appointed to group boards should, by virtue of this appointment alone, be deemed to exercise executive functions.

- Three Member States argue that the strict board independence should not apply to the custodian to whom custody is delegated. The Commission's services point out that the co-legislators extended all requirements applicable to the depositary to a delegate. Hence, it would be difficult to exonerate the custodian in receipt of a delegation from some or all of the board independence requirements.
- One Member State speaks out in favour of the structural separation between asset manager and the depositary (no ownership links) but not between asset manager and custodian to whom custody is delegated. The Commission's services respond that it is difficult to achieve this result as the UCITS V level 1 text applies all requirements applicable to the depositary to the delegate custodian as well. The assumption of the co-legislators was that conflicts of interest would not only arise with respect to the depositary's oversight function but also with respect to custody of assets. These potential conflicts of interest are further described in Section 3.3.2).
- One Member State points out that the Level 2 measures must be adopted before the summer 2015 so that the national implementation of the entire UCITS V Level 1 and Level 2 package can run smoothly. Delays in adopting the Level 2 acts would invariably result in delays in adopting the overall UCITS V reforms.

**Conclusion on topic 1:** Member States agree with the proposed approach not to require structural separation between management/investment company and their depositaries/custodians. They endorse the ESMA/Commission approach to seek independent action of these entities by means of prohibiting personal overlap on both entities' boards. They agree that - in case both entities' form part of the same group - at least two or one third of the board members should not be affiliated with the group. Affiliation would be defined as the existence of "business, family or any other links that give rise to potential conflicts of interest".

#### *Topic 2: Selection of delegates in third countries.*

One Member State contests the necessity that legal advice on the insolvency laws of third countries has to be provided by an independent entity. They argue that in-house lawyers can achieve independent advice as well. The Commission's services respond that the preponderance of stakeholders preferred independent advice to be provided by a third party and not the legal department of the depositary. The Commission's services also point out that cost implication of obtaining independent advice could be mitigated by allowing for the sharing of this advice among members of the relevant industry associations.

**Conclusion on Topic 2:** Member States agree with the proposed selection criteria, including the requirement that legal advice is provided by an independent third party.

## **2.4 Impact Assessment Steering Group and Impact Assessment Board (IAB)**

Work on the Impact Assessment started in June 2014 with the first meeting of the Steering group on 25 November 2014, followed by 3 further meetings, the last one taking place on 16 March 2015. The following Directorates General (DGs) and Commission services participated in the meetings: Financial Services and Capital Markets Union (FISMA), Internal Market, Industry, Entrepreneurship and SMEs (GROW); Justice (JUST); Legal Services (SJ);

Secretariat General (SG); and Trade. The report with the minutes of the last steering group was sent to the Impact Assessment Board on 19 May 2015.

The draft Impact Assessment (IA) report has been examined by the Impact Assessment Board (IAB) by normal procedure as of 17 June 2015. On the basis of the IAB's opinion of 19 June 2015<sup>23</sup> the IA report has been revised in order to take into account the views of the IAB.

#### **1. Protection against insolvency - intervention logic:**

The problem of lack of protection against insolvency in third countries should be clarified in terms of objectives, options and impacts. Further evidence, beyond the Madoff case, should be provided to justify the need to act. This should include explaining why the option of relying on in house lawyers is rejected and how the option of a requirement of independent legal advice will only take effect for certain third countries. It should also be made clear that the industry will be able to share the costs of independent legal advice, thus limiting the additional costs for individual UCITS.

#### **2. Clarification of independence options:**

The role and effective powers of the independent board members should be clarified, in particular with regard to their relationship with regulatory authorities and whistleblowing capacities. The role of the regulatory authorities should also be further explained, including their capacity to oversee boards and intervene on behalf of independent members to prevent any systematic isolation of them.

#### **3. Analysis of impacts:**

The impact of the preferred option on the international competitiveness of the UCITS sector should be spelled out more clearly, in particular by explaining how the regulation would compare to that of other main trading partners. The objectives and expected impacts on the structure of the sector, market concentration and systemic financial risks should be clarified. Moreover, which balance is envisaged between exploiting economics of scale and scope and risks of increasing systemic risks and market power? The report should explain if the increased complexity of the preferred option could in itself be a factor adding to financial risks? The report should also spell out the administrative burdens impact more clearly, including by singling out and assessing those proposed rules and procedures, which will de facto add new administrative burdens to UCITS, while explaining why the others will not generate new burdens. This should include an assessment of whether smaller companies are likely to be affected differently from larger ones. When assessing the costs for depositaries of moving assets to independent custodians, the report should clearly spell out whether the costs considered are one-off or repeated. Finally, the report should better describe the views of different stakeholder groups collected in the consultation on the various options and their impacts.

#### **4. Monitoring:**

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<sup>23</sup> [http://ec.europa.eu/smart-regulation/impact/ia\\_carried\\_out/cia\\_2015\\_en.htm](http://ec.europa.eu/smart-regulation/impact/ia_carried_out/cia_2015_en.htm)

In the monitoring and evaluation part, the report should specify a number of concrete monitoring indicators on the independent board members, such as whistleblowing incidences, regulator interventions and number of board members removed.

### **3 .PROBLEM DESCRIPTION**

#### **3.1 Problems identified in the level 1 impact assessment**

When considering the proposals on the duties and liability for depositaries in preparation of the UCITS V reform in July 2012, the following problems were identified<sup>24</sup>:

- Divergent criteria on eligibility to act as a depositary: The flexibility in choosing which entities can perform the depositaries functions that the Member States have had under Article 23(2) of the UCITS Directive has led to divergent national approaches creating legal uncertainty leading to suboptimal levels of investor protection.
- Unclear rules on delegation of custody: The diversification and internationalisation of UCITS investment portfolios have increased sub-delegation of custody to a wide range of jurisdictions. Increased custody and insolvency risk for those international assets made it necessary to define the conditions applicable in case a depositary further delegates safe-keeping of assets (e.g., objective reason for delegation, level of skill in selecting sub-custodian, intensity of ongoing monitoring of sub-custodian). As explained in the Impact Assessment accompanying the UCITS V proposal<sup>25</sup>, the Madoff case highlights the risks associated with the use of local third country sub-custody networks, especially when the latter do not structurally separate custody from the management of assets.
- Unclear scope of liability in case of loss (including loss when custody has been delegated): The interpretation of the depositary liability in the UCITS Directive has not been uniform which led to differences in investor protection; most notably in the case when a custodial instrument is lost after the delegation of custody. The consequences of these divergences came to the fore with the Madoff fraud. In some Member States the depositary was immediately liable to return assets in custody as a consequence of fraud at the level of the sub-custodian, in other Member States liability is based on fault and is still subject to litigation.

#### **3.2 Scope of the relevant empowerments**

The UCITS Directive provides several empowerments for the Commission to adopt delegated acts covering rules on depositaries' oversight duties, rules on delegation to a third party, insolvency protection and the requirement for depositary and UCITS management/investment company to act independently.

As a consequence, the empowerments for the Commission to adopt delegated acts on depositaries under the UCITS Directive are largely the same as the ones that were foreseen by

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<sup>24</sup> Problems identified in the area of remuneration policies and sanctions are not discussed in this document as there are no level 2 measures directly addressed to these issues.

<sup>25</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52012SC0186>.

the AIFM Directive and for which a Delegated Regulation has been already adopted (see list in Annex 2 and Annex 10 for the comparison of measures).

The delegated acts were drafted to take into account the lessons learned from the Madoff events. Many of the upgrades mirroring the AIFM Directive have already been introduced in the UCITS Directive, notably provisions on the entities eligible to act as depositaries and regarding their liability vis-à-vis the UCITS and its investors. The list of entities that are eligible as depositary function for a UCITS is more limited than those eligible in the AIFM Directive (see Annex 9). Discharge of liability allowed in the AIFM Directive is not allowed for depositaries appointed to safeguard assets belonging to a UCITS. These modifications account for the fact that UCITS are highly regulated retail products.<sup>26</sup>

The only differences in the empowerments for delegated acts between the AIFMD and the UCITS Directive concern the provisions of the UCITS Directive regarding (1) steps that a depositary has to ensure that a third party takes to provide for insolvency protection of UCITS assets and (2) the "independent action" requirement. This impact assessment will focus on the substantive provision which were not addressed in the AIFMD. The other provisions will be cover in Annex 10 and will be based on the AIFMD impact assessment.

**Table 3 – Substantive provisions to be discussed in this impact assessment**

<b><u>Article 22a(3) (d)</u></b>
<i>The functions referred to in Article 22(5) may be delegated by the depositary to a third party only where that third party at all times during the performance of the tasks delegated to it: (d) takes all necessary steps to ensure that in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among, or realisation for the benefit of, creditors of the third party;</i>
<b><u>Article 25(2)</u></b>
<i>In carrying out their respective functions, the management/investment company and the depositary shall act honestly, fairly, professionally, independently and solely in the interest of the UCITS and the investors of the UCITS.</i>

Annex 10 provides an overview of the remaining UCITS empowerments that overlap with those in the AIFM Directive.

### 3.3 Issues to be addressed with the two UCITS-specific empowerments

*Issue 1: Steps that the depositary has to ensure that a third party delegate takes to protect UCITS assets against insolvency<sup>27</sup>*

On the issue of insolvency protection, the Commission's mandate to ESMA provided that ESMA should "specify those steps, in the form of a non-exhaustive list of the measures, arrangements and tasks, that the third party to whom custody function has been delegated

<sup>26</sup> For example, UCITS Directive sets the requirements for eligible assets, diversification ratios, counterparty limits, etc.

<sup>27</sup> See Annex 6 for a description of the problem drivers and problem.



should put in place and perform on an on-going basis in order to ensure that the UCITS assets are protected from distribution among or realisation for the benefit of creditors of the third party". In addition, ESMA was requested to ensure that the required measures, arrangements and tasks take into account the legal framework of the country in which the third party operates, notably that country's insolvency laws and relevant jurisprudence.

Article 22(8) of UCITS V provides that: "Member States shall ensure that in the event of insolvency of the depositary and/or any third party located in the Union to whom custody of UCITS assets has been delegated, the assets of a UCITS held in custody are unavailable for distribution among or realisation for the benefit of creditors of such depositary and/or such third party". Taking into account that the UCITS Directive requires national insolvency laws to be aligned with the above-mentioned requirement, the Commission agrees with ESMA's advice that obtaining a legal opinion on applicable insolvency laws in the EU Member States is not required. In its advice, ESMA rightly confined the requirement of independent legal advice on the applicable insolvency laws to situations where custody over UCITS assets is delegated to third parties located outside the EU.

The insolvency laws and relevant jurisprudence in a jurisdiction outside the European Union may or may not contain specific provisions that require segregation of UCITS' assets, thus helping to make them unavailable for distribution or realisation by creditors of an insolvent custodian of UCITS assets. Consequently, the delegating depositary has to ensure that the local custodian provides the delegating depositary with all necessary assurances so that the UCITS' assets that are held in local custody are considered as segregated and not available to the creditors in case of an insolvency of the local custodian.

The ESMA advice includes a list of steps to be taken by the local custodian to ensure insolvency protection of UCITS's assets. The advice rightly focuses on a series of due diligence requirements that apply both before the delegating depositary enters into delegation arrangements with the local custodian and during the entire duration of these arrangements.

In light of the above, this impact assessment endorses the advice delivered by ESMA which provides sufficient degree of details and analyses the impact of the options. The details of the ESMA advice and the proposal of the Commission are described in Annex 11. The Commission follows this advice subject to some adjustments of legal drafting because, the ESMA advice on this issue:

- 1) is robust enough to rely on,
- 2) follows international standards on protection of client assets<sup>28</sup>.
- 3) does not raise significant market impacts and was not controversial in the course of ESMA's stakeholder consultation.

#### *Issue 2: The independence of action requirement*

Several UCITS funds suffered several billions of euros in losses due to the Madoff fraud. This fraud arose in a situation where the management of the portfolio as well as custody of the portfolio was delegated to the same third party - Bernard L. Madoff Investment Securities

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<sup>28</sup> See IOSCO Recommendations Regarding the Protection of Client Assets of January 2014 <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD436.pdf>

LLC<sup>29</sup>. This lack of separation between the asset manager and the depositary functions, combined with a lack of transparency and due diligence, facilitated a fraudulent investment strategy to go undetected for several years.

Moreover, a typical UCITS fund uses several service providers (external or internal) to operate and execute its investment strategy. Normally, the fund relies on an investment manager to manage the assets, one or several brokers to execute trades, a fund administrator to calculate the value of the fund's investments and a custodian to safe-keep financial instruments held by the fund. While being obliged to work together, these service providers must be independent of each other and the exercise of their respective tasks should be strictly separate. In particular, the depositary which is entrusted with the central role of oversight over all UCITS assets should be able to exercise its tasks in line with applicable rules and be able to report cases of irregularities in full independence. To address this problem, Article 25 of UCITS, already prior to the UCITS V reform, establishes the independence of both asset management and depositary functions: Article 25 of UCITS IV states that (1) no company shall act as management/investment company and depositary; and (2) in the context of their respective roles, the management/investment company and the depositary shall act independently and solely in the interest of the unit-holders.

UCITS V does not modify the above points mentioned in the Article 25. The basic rule remains that (1) no company shall act as both management/investment company and depositary; and (2) in carrying out their respective functions, the management/investment company and the depositary shall act honestly, fairly, professionally, independently and solely in the interest of the UCITS and the investors of the UCITS.

While the substantial requirement that management/investment companies and the depositary act independently in performing their respective tasks has not been altered by the UCITS Directive, the reform introduces a new empowerment whereby the European Commission shall adopt a delegated act specifying the conditions for fulfilling the "independent action" requirement.

In addition, paragraph 3(e) of Article 22a extends the general requirements applicable to depositaries also to the third party to whom the depositary has delegated custody of the UCITS assets.

Furthermore, the UCITS Directive addresses a specific case of the conflict of interest which might arise in cases where depositaries offer services other<sup>30</sup> than depositary or custody services<sup>31</sup>. It states that, the depositary cannot carry out activities on behalf of the UCITS 'that may create conflicts of interests between the UCITS, the investors in the UCITS, the management company itself, unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the UCITS' (Article 25 (2) second subparagraph).

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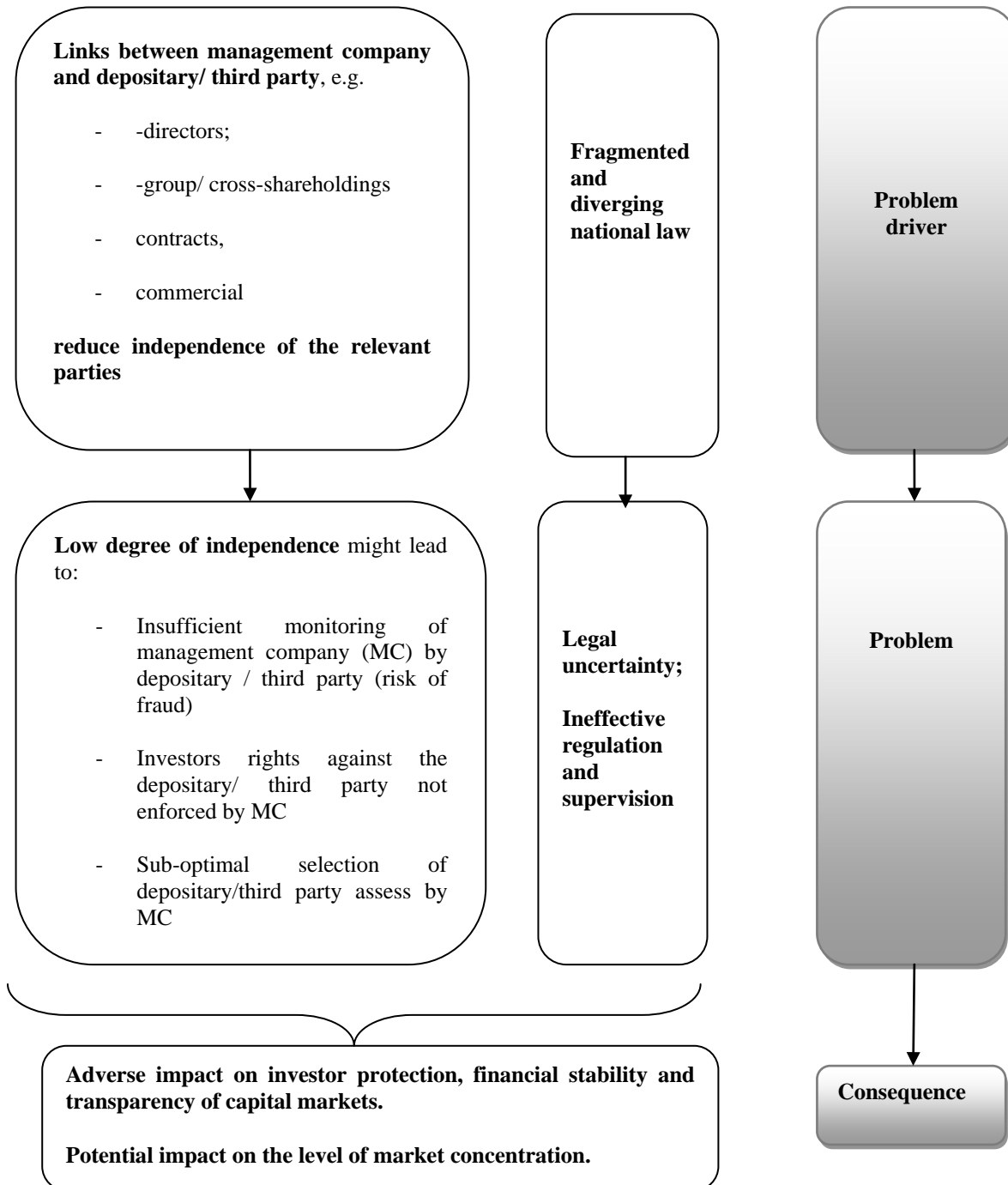
<sup>29</sup> Annex 7 provides a background to the Madoff fraud.

<sup>30</sup> For example, prime brokerage, treasury and securities lending, collateral management, etc.

<sup>31</sup> Annex 4 describes the list of all the services done by a depositary.

The following chart explores the different elements that are relevant when analysing whether depositaries on the one hand and management/investment companies on the other hand act independently.

**Chart 2 – Problem description – independence**



### *3.3.1 Problem drivers*

The independence of the UCITS management/investment company and the UCITS depositary / third party to whom the custody function has been delegated might be undermined by existence of various links between the two entities<sup>32</sup> as illustrated in the Madoff scandal.

This issue is identified in the consultation report of IOSCO on principles regarding the Custody of Collective Investment Scheme's Assets<sup>33</sup>. IOSCO recommends, in its principle 4 that, "the custodian should be functionally independent from the responsible entity". IOSCO recognised that this functional independence may be achieved in a variety of ways. A functional separation should necessarily imply a hierarchical separation, which will involve assessing where key decisions are taken.

There are at least four relevant links between the relevant parties: (i) common directors; (ii) affiliated directors<sup>34</sup>; (iii) group membership/cross-shareholdings; and (iv) contractual links. The independence of the relevant parties is affected if one party can control action of the other or if one party can control the action of the asset manager and the depositary concurrently (the parent company of a group) by means of (i) executive power in the case of common directors<sup>35</sup>; (ii) shareholders' vote in the case of group membership/cross-shareholdings; or (iii) contractual commitments in the case of contractual links.

The independence of the depositary/third party (to whom the custody has been delegated) or the management/investment company may also be affected by commercial links. The entity which acts as a depositary/third party (to whom the custody has been delegated) might provide additional/ancillary services to the management company such as securities lending and collateral management or execution of foreign exchange transactions. The interest in the revenue associated with providing additional services to the management company might conflict with the depositary's duty to monitor the management/investment company and spot irregularities in its activities (e.g., Article 22(3)(c) UCITS states the depositary has to: "carry out the instructions of the management company, unless they conflict with the applicable national law or the fund rules" and according to Article 22(3)(e) the depositary has to "ensure that a UCITS's income is applied in accordance with the applicable national law and the fund rules").

National laws vary widely across the Member States both in terms of interpretation of permissible links and in terms of the condition of corporate rule applicable to depositary

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<sup>32</sup> To simplify the exposition, the problem description focuses on the independence of the UCITS management company and the UCITS depositary but is applicable also with respect to their delegates.

<sup>33</sup> <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD454.pdf>

<sup>34</sup> As opposed to common directors, affiliated directors are individuals that are not employed by one of the entities involved but that are bound to one or both of the entities by other links than employment.

<sup>35</sup> In addition to common directors, this might include provisions on quorum, simple majority or super majority votes, and restrictions on decision-making capacity of certain directors, and directors having shareholdings in the relevant party. Directors' remuneration will also have impact on their independence.

business<sup>36</sup>. A number of Member States limit the possibility of common directors and/or senior managers (IT, DE, UK, FI, LU, RO, AT, MT, BE, IE, LT) or impose some form of 'functional' independence (CY, SE). Two Member States limit corporate cross-shareholdings between the two entities (UK, SL). Two Member States prevent directors of the depositary from managing/supervising certain activities provided by the depositary to the management company (e.g. brokerage) – RO, SI. Several Member States do not have specific provisions in their national law.

In terms of group structure, most Member States (except UK<sup>37</sup> and SL) permit the management company and the depositary to be part of the same (usually banking) group. However, most of these jurisdictions, including the UK and SL, have no structural separation requirement that applies to the third party to whom the custody has been delegated. This implies that the third party custodian can belong to the same corporate group as the management company.

### 3.3.2 Problems

The above links between a depositary/third party to whom the custody has been delegated and a management/investment company could give rise to the following conflict of interests:

- Risk of fraud if both depositary and asset manager belong to the same corporate group; in this scenario irregularities in the accounts may not be reported to the competent authorities as this would affect the reputation of the banking group (**fraud risk**)<sup>38</sup>;
- Risk of investor detriment in case UCITS assets are lost in a group depositary's custody; in this scenario the management company might prove reluctant (or even be prevented by its rules of incorporation) to take legal steps against the depositary in order to obtain restitution of the lost assets or compensation for the benefit of the UCITS or the UCITS investors (**legal recourse risk**);
- Risk of investor detriment if the management company selects a depositary within the same group: this choice might be influenced by factors other than quality and price (**selection bias**);
- Privileging an intra-group depositary<sup>39</sup> might lead to lower standards in asset segregation and/or reduced vigilance or laxer safeguards against the insolvency of the depositary or its delegates (**insolvency risk**);
- Appointing an intra-group depositary is often associated with UCITS that invest in financial instruments<sup>40</sup> that are issued by the group; in this scenario there is a risk of

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<sup>36</sup> Initial mapping of national implementing measures of independence principle is described in the ESMA consultation document: <http://www.esma.europa.eu/system/files/2014-1183.pdf>

<sup>37</sup> The United-Kingdom does not allow the depositary to be in-house but allows on a case-by-case basis the delegation of the asset's safekeeping to the custodian who is part of the same group as the asset management company.

<sup>38</sup> This risk materialised in the Madoff case.

<sup>39</sup> Section 1.4 shows where the management company is part of a banking (depositary) group, it will appoint the in-house depositary for its UCITS.

excessive "single group" exposure as the manager, the depositary and the investment assets are all reunited within one corporate group (**single group exposure risk**).

In addition, diverging rules on the permissible links between depositaries/third party to whom the custody has been delegated and management/investment companies across Member States may create legal uncertainty in many cross-border situations, e.g. when the management company and the depositary are not in the same Member State or when management/custody of UCITS assets is delegated to entities domiciled in other Member States.

### *3.3.3 Consequences*

The persistence of the above-mentioned conflicts of interest could have adverse impacts on consumer protection, financial stability<sup>41</sup> and the functioning of the capital markets. The lack of clarity would leave UCITS management companies, depositaries/third party delegates and national competent authorities with an unclear framework in which to assess whether the UCITS management/investment company and depositary/third party delegate act independently in carrying out their respective functions.

## **3.4 How would problems evolve without action?**

The large scale of the Madoff fraud went undetected for a long period because the depositary responsible for the safekeeping of the fund assets delegated custody over these assets to the same entity run by Bernard Madoff to which the management of investments was delegated. Moreover, information regarding the delegation has never been disclosed to investors. In this case, the relationship between the asset manager and the depositary / third party (to whom the custody has been delegated) has created the situation of clear conflict of interests and increased the operational risk.

The UCITS Directive already provides for mitigation measures to address major risks related to the safekeeping of assets (strict liability regime for the depositary, clarification of the depositary duties, clear rules on sub-delegation of custody and the prohibition of the reuse of assets for the depositary's own account). If nothing were done to specify the requirement of what constitutes independent action of the depositary/third party to whom the custody has been delegated and the management/investment company, certain operational risk mentioned in the problem description would still remain. In particular, the oversight functions of the depositary could not be exercised in full independence in case of potential failures in the trading, valuation or cash flows monitoring. On the other hand, if structural and personal links that could give rise to the conflicts of interest mentioned above are not properly covered, this will not ensure enough safeguard to investors.

## **3.5 Subsidiarity and proportionality**

Due account was taken of the principles of subsidiarity and proportionality.

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<sup>40</sup> Instances where the management company invests predominantly into financial instruments issued by the own banking (depositary) group include MMF and derivative based ETFs ("total return swaps").

<sup>41</sup> A large fraud might even lead to the insolvency of the depositary.

The empowerments to adopt delegated acts in order to further specify several provisions concerning depositary rules are contained in the UCITS Directive. By introducing these empowerments, the co-legislator aims to increase the degree of harmonisation across the Union. It was felt that the issues covered by the empowerments should not be left to potentially divergent national approaches. The requirement that an asset manager and its depositary act independently is a requirement where Member States took different approaches (see Section 3.3.1). The mapping of national measures ensuring independent action of depositaries and management/investment companies conducted by ESMA showed that national measures enacting this principle are not homogeneous and in some cases no measures were in place. There is therefore a clear indication that leaving the issue of defining independent action to Member States will not achieve a common level of investor protection. Therefore, exercising this empowerment respects the principle of subsidiarity.

In accordance with the principle of proportionality Union measures do not go beyond what is necessary in order to achieve the stated objectives. The proposed measure respects deal with both the issue of insolvency protection and independent action in a proportionate manner. More incisive measures that bring little added value, such as the requirement of a strict structural separation between asset manager and its depositary were discarded in favour of less incisive, but equally efficient, requirements as to the independence of the management boards of both entities. Equally, in relation to the "insolvency proofing" of assets in case of delegation to a third party, the strict requirement of an independent legal opinion is mitigated by allowing the sharing of such opinions between several members of an industry federation.

## **4 OBJECTIVES**

### **Table 4- General, specific and operational objectives in the depositary rules**

#### **General objectives**

- Increase the level of UCITS investor protection, aligning the UCITS and AIFMD standards on the duties and responsibilities of fund depositaries.
- Design a framework on the duties and responsibilities of UCITS depositaries that takes into account that UCITS is a retail investment scheme.
- Ensure financial stability and transparency of capital markets while avoiding negative repercussions on the level of market concentration.

#### **Specific objectives**

- Ensure adequate protection for UCITS assets that are held in custody with a UCITS depositary and its network of sub-custodians
- Ensure that UCITS asset manager and UCITS depositaries act independently: Avoid conflicts of interests that arise when a UCITS asset manager and a UCITS depositary are linked by cross-shareholdings or belong to the same corporate group, especially when asset managers select a depositary for the safe-keeping of UCITS assets
- Achieve the above specific objectives whilst ensuring that the market for asset management, depositary and custody services remains competitive

## Operational objectives

- Ensure that delegation arrangements provide for protection of UCITS assets in case custody is delegated to third parties
- Ensure that governance arrangements are in place, both at the level of the UCITS asset manager and at the level of the UCITS depositary that ensure independent behaviour of both entities, especially when these entities are linked by cross-shareholdings or when both entities belong to the same corporate group.
- Achieve the above objectives operational objectives while ensuring the existence of a diversified range of UCITS depositaries so that a UCITS asset manager always has a choice of several competing depositaries (avoiding further concentration of the markets for depositary and custody services).

## 5 ANALYSIS OF OPTIONS

The objective of Article 25 of the UCITS Directive is to ensure the protection of UCITS investors' interest. In order to achieve this objective, Article 25(1) UCITS prohibits one entity to act as both the management/investment company and the depositary/third party to whom custody is delegated<sup>42</sup>. The UCITS Directive, on the other hand, does not prohibit that the separate entities can be linked by cross-shareholdings between themselves or that these entities belong to the same group/

In order to address potential conflicts of interest that are always present in case both entities have common management, but also arise in a scenario where both entities are linked by cross-shareholdings or and membership of a corporate group, Article 25(2) UCITS requires that, in carrying out their respective functions, the management/investment company and the depositary/third party to whom the custody has been delegated, act honestly, fairly, professionally, independently and solely in the interest of the UCITS and the investors of the UCITS.

In preparing the exercise of the UCITS V empowerment (whereby the European Commission shall adopt a delegated act specifying the conditions for fulfilling the "independent action" requirement), this impact assessment will address the issue of independent action by identifying all personal and corporate links between the management/investment company and the depositary/third party to whom the custody function has been delegated.

With respect to personal links, this impact assessment will focus on conflicts that arise when the persons involved in management or supervision of management/investment company and the depositary/third party delegate are identical.

In addition, this impact assessment will analyse corporate links which are either those that exist either by virtue of cross-shareholdings between these entities or links that are due to both entities forming part of a single corporate group.

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<sup>42</sup> The cross reference in Article 22a paragraph 3(e) to Article 25 UCITS imposes the independence of action requirement also on a third party to whom the depositary has delegated all or part of its safekeeping functions.



The table below identifies the relevant options to address both scenarios that could give rise to conflicts of interest.

Policy options	Summary of policy options
<b>Part I: Options to address common management</b>	
Option 1.1 Do nothing (baseline scenario)	<p>The adoption of the delegated acts on independent behaviour of UCITS asset managers and UCITS depositaries are mandatory. There is a policy choice as to the execution of the empowerment (see options below), not whether to exercise the delegated powers.</p> <p>Apart from a failure to comply with secondary law, not exercising the empowerment on "independent action" would result in the persistence of divergent interpretation by Member States of what has to be understood by "acting independently".</p> <p>The more general consequence of not clarifying the precise obligations ensuring independent action would be a loss in trust in the UCITS "label" with investors in Europe and in a variety of third countries where UCITS are bought.</p>
Option 1.2 Prohibit "double membership" of both entities' (asset manager and depositary) boards	<p>No member of the management body or an employee of one entity shall be appointed to the management body of the other entity. The rationale behind a prohibition of "double membership" is: independent action of the management boards of the asset manager and the depositary/third party custody delegate is affected should one of these entities, by virtue of common directors, be in a position to control the action of the other. This conflict is especially acute when it comes to the selection of the depositary.</p> <p>However, when the management board is different from the supervisory board ("dual board structure"), this option allows that one third of the members of the supervisory board can be identical to those on the supervisory board or management board of the other entity. This relaxation is due to the additional layer of scrutiny provided by the dual board structure.</p>
Option 1.3 Permit "double membership" but limit the voting rights of members that are on both boards	This option introduces a limitation of the voting rights in case the same person is a member of both entities' boards. This option aims to avoid that a member sitting on both boards partakes in decisions in which this member's "double membership" would give rise to conflicts of interest.
Option 1.4 Permit "double membership" but prohibit "double members" from having a direct or indirect shareholding in both entities	This option would allow persons to sit on the board of both entities (asset manager and depositary) as long as these "double members" have no additional conflicts of interest on account of their shareholdings on one or both entities.

Part I of the table identifies three options to address conflicts of interest that could result when the asset manager and the depositary or third party to whom custody has been delegated have common management. Part II of the table addresses additional situation where these conflicts could become equally acute, such as (1) cross-shareholdings / group companies ("corporate links") or (2) the fact that both the asset manager and the depositary/third party delegate belong to the same corporate group.

<b>Part II: Options to address conflicts that arise when managers and depositaries have corporate links or belong to the same group</b>	
Option 2.1 Do nothing (baseline scenario)	<p>Same as the baseline scenario described under Option 1.1.</p> <p>If no additional safeguards were introduced, the specific conflicts that arise when both the asset manager and the depositary belong to the same group or are linked by cross shareholdings will remain unaddressed. National competent regulators would, also in this delicate scenario, remain reliant on the general principle enshrined in Article 25 (2) UCITS which requires that, in carrying out their respective functions, the management/investment company and the depositary/third party to whom the custody has been delegated, act honestly, fairly, professionally, independently and solely in the interest of the UCITS and the investors of the UCITS.</p>
Option 2.2 Require structural separation between the management company and the depositary	Management/investment company and depositary/third party to whom the custody has been delegated cannot have cross-shareholdings between themselves or belong to the same corporate group.
Option 2.3 Additional corporate governance safeguards when asset managers and depositaries/third party custody delegates have cross shareholdings <sup>43</sup> or when they belong to the same group (for the purpose of consolidated accounts). <sup>44</sup>	<p>A series of additional governance requirements aim to ensure that asset managers/depositaries/third party custody delegate that have cross-shareholdings amongst each other <u>or</u> that belong to the same group as a depositary (1) avoid conflicts of interest and, when they cannot be avoided, manage and appropriately monitor these conflicts of interest; (2) demonstrate, to the satisfaction of the competent authority, that the appointment of the depositary/third party custody delegate is in the sole interest of the UCITS and the investors of the UCITS; (3) disclose corporate links between themselves; and (4) justify<sup>45</sup> the choice of depositary/third party custody delegate vis-à-vis UCITS investors. In addition, when both entities when they belong to the same group, this option requires the appointment at least one-third or two independent members<sup>46</sup> to both entities' management or supervisory boards.</p>

## 6. ANALYSIS OF IMPACTS AND CHOICE OF PREFERRED OPTIONS

This section sets out in the form of summary tables the advantages and disadvantages of the different policy options, measured against the criteria of their effectiveness in achieving the related objectives (to be specified for each basket of options), and their efficiency in terms of achieving these options for a given level of resources or at least cost. Impacts on relevant stakeholders are also considered.

<sup>43</sup> For the purpose of Option 2.3, cross-shareholdings are relevant once the direct or indirect holding of one entity (asset manager/depositary/third party) in another entity (asset manager/depositary/third party) represents 10% or more of the capital or of the voting rights or if the shareholding makes it possible to exercise a significant influence over the other entity

<sup>44</sup> As defined in Directive 2013/34/EU or in accordance with international accounting rules

<sup>45</sup> An appropriate justification requires putting in place a robust and transparent selection process, which shall be based on objective pre-defined criteria and meet the sole interest of the UCITS and the investors of the UCITS.

<sup>46</sup> According to ESMA, only members of an entity's board will be deemed independent if they have no business (including shareholding links), family or other relationship with the members of the board of: (1) a management company/investment company, (2) a depositary or (3) any of the other undertakings within the group that would create a conflict of interest.

The options are measured against the above-mentioned pre-defined criteria in the tables below. Each scenario is rated between "---" (very negative), 0 (neutral) and "+++" (very positive).

Comparison of options (the preferred options are highlighted in bold and underlined in light grey)

Policy Option	Impact on stakeholders	Effectiveness	Efficiency
<b>Part I: Options to address common management</b>			
<b>1.2 Prohibition of double membership</b>	(++) Provides the clearest safeguard to ensure independent behaviour of both boards. Easiest to enforce by competent national authorities. (++) has the advantage of addressing the core issue raised in Madoff.	(++) Reinforces investor confidence by ensuring that the management or supervisory boards of all relevant entities (manager/depositary/custody delegated) act in full autonomy of each other. By tackling obvious conflicts of interest this option is effective in restoring fund investors' confidence.	(--) Additional cost of paying the annual remuneration of additional board members as "double membership" is being phased out. (+) Neutralisation of additional cost burden, as executive board directors are rarely compensated for their position on a board (executive directors receive a global compensation package which includes compensation for board attendance) (+) Neutralisation of cost burden as academics often sit on boards without remuneration. (+) Additional mitigation for "dual board" entities: these entities are not obliged to staff both boards with entirely separate directors. Significant mitigation results from the 1/3 'dual membership' privilege: the cost of a board member varies between € 10.000 and 30.000. <sup>47</sup>
1.3 Permit "double membership" but limit the voting rights of members that are on both boards	(+) Less costly implementation for the two entities (potential savings in terms of annual remuneration and 'executive search' cost in identifying board members to replace double members) (-) Loss of investor trust when all the members of the management boards of both entities are identical.	(-) Option is difficult to enforce as supervisors will have to make a case-by-case assessment of whether voting on a matter would be tainted by a conflict of interest. (-) the option ensures only a moderate level of investor protection and confidence as limits on voting rights in cases of conflict of interest are already part of corporate governance requirements applicable to all board members.	(-) Influence of "double members" is not only present in voting. Other channels of influence remain unaddressed. (-) Difficult for competent authorities to enforce as the identification of a conflict of interest (with a subsequent enforcement of a limitation in voting rights) requires a 'case-by-case analysis of the subject matter to be decided by the board.
Option 1.4 Permit "double membership" but prohibit "double members" from having a direct or	(+) Less costly implementation for the two entities (potential savings in terms of annual remuneration and 'executive search' cost in identifying board members to replace double members) (-) Loss of (institutional) investor trust when <u>all</u> the members of	(-) Option does not solve the problem of conflict of interest when the member of the management body sits in both boards (double membership) without having shareholdings.	(-) The influence of those members that are members of both boards can be important whether they have a shareholding in the other entity or not (-) Conflict of interest of "double members" is not confined to cases of those members having shareholdings in one or both entities. Mere "double membership" can also give rise to

<sup>47</sup> Data supplied by the competent national regulators in Luxembourg, Ireland, the United-Kingdom and France.

indirect shareholding in both entities	the management boards of both entities are identical.		conflicts. (-) Difficult for competent authorities to enforce as the identification of a conflict of interest requires a 'case-by-case' analysis involving verification of the share portfolio that is held by individual board members
<b>Part II: Options to address conflicts that arise when managers and depositaries have corporate links or belong to the same group</b>			
Option 2.2 Structural separation between the management company and the depositary/third party custody delegates	(--) large scale restructuring of custodial assets in most Members States (at least € 2.5 trillion or 32% of EU domiciled UCITS assets may be affected <sup>48</sup> ) without, however, entailing an immediate improvement of competition in the European depositary markets (--) One off cost transferring custody is estimated at € 125 million for the EU. (--) Transfer of custody cost will directly impact custody fees and, in turn, fund management fees paid by UCITS investors.	(++) Limits the influence that one entity can take on decisions taken by the other (e.g., on selecting a depositary) (--) fails to capture "channels of influence" that do not rely on cross-shareholdings or that arise outside of a corporate group (business or personal relationships)	(--) Significant cost to achieve a 'partial' result as other channels of influence remain unaddressed. (--) Partial approach to safeguarding "independent behaviour" risks in increasing already significant levels of market concentration in the area of depositary/custody services. (--) Extremely negative impact on the international competitiveness of the EU asset management sector as all major competitors do not require structural separation between asset manager and depositary <sup>49</sup> . According to an IOSCO consultation paper regarding custody of collective investment schemes' assets (published in October 2014) most important asset management jurisdictions allow self-custody in their jurisdiction: the US, the UK, Jersey and Australia allow self-custody in their jurisdictions (see footnotes 16 and 17 of the consultation paper: <a href="http://www.iosco.org/library/pubdocs/pdf/IOSCPD454.pdf">http://www.iosco.org/library/pubdocs/pdf/IOSCPD454.pdf</a> ) (--) Entails a large scale restructuring of custodial assets in most Members States without entailing an improvement of competition in the European depositary/custodial service markets (--) Reinforces the risk that operational failures or bankruptcy of a large depositary/custodian could negatively impact the functioning of financial markets as a whole, especially if the failing entity impedes the ability of other institutions to meet their obligations; reinforces the systemic risk of exposure to a single financial counterparty <sup>50</sup> (--) Loss of economies of scale in individual national markets, especially in small Member States and Member States with small UCITS segments.

<sup>48</sup> See Table 6 in Annex 5.

<sup>49</sup> See Annexes 13 and 15.

<sup>50</sup> See Annex 15

<b>Option 2.3</b> <b>Corporate governance safeguards when asset managers and depositaries / third party custody delegates have cross shareholdings or when they belong to the same group</b>	(-) Limiting costs to annual remuneration to be paid to two independent board members. Across the EU, these costs would not exceed annual remuneration payments of approximately € 3.7 million. (+) Maintains a competitive market structure both in asset management and in the provision of depositary/custodial services (+) Less risk of additional concentration in the depositary market (systemic risk). (++) avoids a repeat of the Madoff scenario where entities had mostly identical members/no members that were entirely independent of the Madoff entities.	(++) The presence of two independent board members takes a holistic approach in tackling "channels of influence" that can result from corporate links, group membership and other personal or commercial links of individual board members. (++) In line with IOSCO principles on the custody of collective investment schemes <sup>51</sup>	(+) Annual remuneration of independent board members could be compensated for by reducing the overall number of board members (cost neutrality). (+) in order to introduce proportionality, independent board members are not required in the case of cross-shareholdings, but only for 'group' companies. (++) Addresses conflicts of interests in a holistic manner allowing smaller managers and depositaries to maintain economies of scale allowing them to remain a source of actual or potential competition in the relevant markets (safeguard against concentration risk). (+) Limiting costs for SMEs as it allows appointing only one third of independent members when the board is composed of 2 or 3 members. (+) Keeps EU rules aligned with the consensus view prevalent in all major asset management jurisdictions: Some of the EU's most important competitors in asset management allow self-custody in their jurisdiction: the US, the UK, Jersey and Australia allow self-custody in their jurisdictions (see footnotes 16 and 17 of the IOSCO consultation paper). In particular, Option 2.3 resembles Rule 206(4)-2 of the US <u>1940 Investment Advisers Act</u> . Rule 206(4)-2 which also does not require use of independent custodians. Rather, Rule 206(4)-2 imposes additional requirements when client assets are maintained by the adviser itself or by a "related person" instead of an independent qualified custodian. A "related person" is defined in rule 206(4)-2 as any person, directly or indirectly controlling the adviser, controlled by the adviser or under common control with the adviser ("group scenario")
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## 6.1. Choice of preferred option to address "common management"

### Effectiveness

For the reasons set out in the table above, a large majority of respondents (including management companies, depositaries, banks and investors representatives) to the ESMA consultation agreed that common staff on the management/supervisory boards of the asset manager and the depositary might indeed prevent independent behaviour of the two entities. This large majority of respondents of the ESMA consultation agreed that **Option 1.2** would be most effective in addressing these conflicts.

### Efficiency

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<sup>51</sup> See Annex 15

Several respondents of the ESMA consultation mentioned the difficulty of providing precise data and additional costs associated with the phase-out of overlapping memberships in both entities' management bodies. Other respondents mentioned that costs would be incurred and would be linked, inter alia, to the need to – at a minimum – appoint new personnel and remove existing personnel.

However, a number of respondents (including, banks, management companies and depositaries) also mention that the rule against "double membership" is likely to lead to only limited additional costs, especially if the alleviations proposed in the case of "dual board" entities would apply. In addition some Member's States such as Spain have already a prohibition of double membership. This prohibition of double membership in Spain has not resulted in management companies or depositaries facing substantial additional cost burdens.

Certain depositaries which are part of the same group as the UCITS management/investment company would have to make, sometimes significant, changes to their board. They will, for example in some cases, have to replace half of the members of the management body of the depositary or management company. On the other hand, avoiding overlapping membership provides a non-tangible reward as investors' confidence in the group entity is strengthened.

The appointment of additional board members would, as mentioned above be confined to the annual cost of remunerating a director. The remuneration of a director (whether independent or not) amounts to between €10,000 and €30,000. Taking into account the worst case scenario mentioned above (half of the members of both entities' board have to be replaced), the additional cost for small boards (comprising three or four members) or large boards (comprising five to seven members) would, on average, not exceed:

- € 80,000 annually for small boards which need to appoint a maximum two replacements for each board
- € 120,000 for large boards which need to appoint a maximum average of three replacements on each board.

In addition, **Option 1.2** takes into account the special situation of "dual board" entities where two boards (a management and a supervisory board) would need to be staffed with entirely different directors. In extreme cases, **Option 1.2** could cause costs of up to €420,000 per year (assuming that each entity has to staff two boards comprising seven members and that hitherto both boards were staffed with identical persons). **Option 1.2** will mitigate the potentially high cost inherent in such a requirement by stating that the supervisory board of one entity (e.g., the asset manager or the depositary) would only need to comprise at least five directors which are not represented on the board of the other entity (e.g., the depositary or the management company). Therefore, if management and supervisory boards are distinct in both the asset manager and the depositary, additional cost at supervisory board level should be at maximum €150,000 (= five new directors).

In addition, the "dual board" alleviation is not conducive to reducing investor protection because in a two tier system the supervisory board carries out an independent control over the management board. The supervisory board effectively introduces an additional layer of scrutiny as it nominates and selects or dismisses the members of the management board and

approves the latter's strategic plan<sup>52</sup>. The supervisory board is a serious layer of control as its members are separately liable vis-à-vis the company for any breach of their supervisory duties.

The Commission's services therefore deem that the above mentioned cost estimates provide a comprehensive picture of additional costs inherent in **Option 1.2**.

**Options 1.3 and 1.4**, while providing more flexibility to the industry, would not provide an enforceable level of safeguards against potential conflicts of interests. Under the two other options, it would be difficult to determine the limits imposed to the decision-making capacity of the members of the management body and, therefore, it may be difficult for supervisors to enforce the rule. Finally, as the application of these options will be contingent on a case-by-case assessment, the rule risks not being transparent to both investors and supervisors. **Options 1.3 and 1.4** will not, therefore, provide sufficient safeguards as to the absence of conflicts of interest to UCITS investors.

**Options 1.3. and 1.4.** also do not provide the same degree of investor protection as to the absence of potential conflicts of interest. Especially the fact that members of both entities' boards would still overlap would entail a heightened risk that the entities would not act independently of each other and disregard the interests of UCITS investors in favour of corporate interests. These options would therefore not provide a requisite level of certainty that the boards of the management company and that of the depositary act independently.

Moreover, **Option 1.4** seems especially ineffective in preventing conflicts of interests as the as personal shareholdings held by individual board members are difficult to apprehend and subject to frequent change.

In light of these considerations **Option 1.2** is the preferred option.

***Table 5 - Independence requirement – common management- comparison of options***

	<b>Effectiveness Investor protection</b>	<b>Efficiency Limiting administrative burden</b>
<b>Option 1.2: strict prohibition</b>	++	--
Option 1.3: limits on members	+	-
Option 1.4: prohibit any member from having shareholding linked	+	-

*Magnitude of impact as compared with the baseline scenario: ++strongly positive; + positive; - - strongly negative;- negative; ≈marginal; ? uncertain; n.a. not applicable.*

## **6.2. Choice of preferred option to address conflicts that arise when managers and depositaries have corporate links or belong to the same group**

### Effectiveness

While **Option 2.2** might be conducive toward fostering independent behaviour between a management/investment company and its depositary/third party to whom the custody has

<sup>52</sup> The two tier system is mainly found in Germany. The functioning of the two tier system is defined in Corporate Governance law and Corporate Governance Codes (German Aktiengesetz and the German Corporate Governance Kodex).

been delegated, structural separation by itself falls short of addressing other more relevant "channels of influence", such as: (1) identity of individuals sitting on both entities' governing boards or (2) personal links that exist when board members in one entity have personal or contractual links to the other entity or the group company. **Option 2.2** would therefore have to be complemented to measures akin to those that constitute **Option 1.2** (dual membership) and **Option 2.3** (corporate governance safeguards).

**Option 2.2** does not prevent the possibility of one entity or the group to exert decisive influence by virtue of the ability to appoint affiliated directors or members<sup>53</sup> to the board of the other entity. In light of these shortfalls, addressing potential conflicts of interest by means of structural separation alone is deemed insufficient.

**Option 2.3** will provide the additional safeguards aimed at avoiding conflicts of interest, increasing transparency to investors and strengthening the independence of the governing bodies of the two entities that display corporate links or belong to a corporate group. **Option 2.3** will address the above mentioned conflicts of interests/risks that might result out of cross-shareholdings and group membership in the following manner:

Risk/ Conflict of interest	Description	How the preferred Option will cover this risk?	Additional safeguards
Fraud Risk	Avoid irregularities in the accounts to be unreported to the competent authorities	<p><b>Option 2.3</b> requires management body to have one-third or at least two independent members sitting on both boards in the case belong to the same group. Independent members, on account of their duties and liability in case of failure to execute these duties<sup>54</sup>, are a safeguard against irregularities going unreported.</p> <p><b>Option 1.2</b> is complementary to <b>Option 2.2</b> as it will ensure that members who will take the decision in one board are not the same as those</p>	<p>According to national corporate governance rules, the views of independent board members cannot be ignored due to the fact that minutes of board meeting are recorded. National regulators can request access to these board minutes as part of their general supervisory powers<sup>55</sup>.</p> <p>A board member may also use also the whistleblowing procedure introduced by UCITS V.</p> <p>The effectiveness of independent board members as a voice independent from either the (1) asset management company,</p>

<sup>53</sup> Affiliated members are defined as members of the other entity's management body, the other entity's employees as well as members of the group management body or as employees of the group or as having a contractual agreement with the group or an entity of the group.

<sup>54</sup> See, for example, Section 18 par. 4 (**Kapitalanlagegesetzbuch - KAGB**) which requires that "The personality and expertise of the members of the supervisory board or of an advisory board shall be such as to guarantee the protection of the investors' interests. ..." In practice, this implies that, should the competent regulator (BaFin) discover that a majority of board members persistently ignore legitimate concerns of one or two members, it may take the view that all or some of the majority members are no longer suitable for their board position and request their dismissal. In Ireland, acting as a director is a "pre-approval controlled function" which requires approval by the Irish Central Bank under the **Fitness and Probity** regime. The Irish Central Bank has a range of powers available to it to investigate, suspend, remove or prohibit individuals from controlled functions where concerns arise about their fitness and probity.

<sup>55</sup> See, for example Section 5 par. 6 of the German Capital Investment Act (**Kapitalanlagegesetzbuch - KAGB**) which equips the supervisory authority, BaFin, with comprehensive investigation and intervention powers. Based on this empowerment, BaFin may, e.g., request the minutes of meetings of the supervisory board from a fund management company or a fund depository should there be any indication of a breach of law or non-compliance with the fund rules. If a member of the supervisory board expresses concerns in this regard, BaFin will have to further investigate whether these concerns are based on facts. If BaFin concludes that there is any breach of law or non-compliance with the fund rules, it will issue the orders necessary to remove the breach and avoid further breaches.



		sitting on the other entity's board.	
Legal recourse risk	In cases of double membership of boards, joint membership of manager and depositary in a group or cross-shareholdings between both entities, reluctance of management to take legal action when UCITS assets are lost in custody.	<b>Option 2.3</b> establishes a quorum of 1/3 or 2 members which must have no links to the other entity or the corporate group to minimise the risk that adequate legal recourse is not taken.  Furthermore, <b>Option 1.2</b> will minimise conflicts resulting from dual membership.	(2) the depositary or (3) the group entity to which both entities belong results from the fact that the views of independent board members are recorded in the minutes of the board meeting. Depending on the gravity of the situation, the competent regulator would expect the board member whose views are being ignored to inform the regulator of any concerns in compliance the new whistleblowing procedure introduced by UCITS V <sup>56</sup> .
Selection bias	Selection bias to favour appointing a depositary within the group, a company which is linked by cross-shareholdings or dual membership of company boards.	In addition to the appointment of independent members, <b>Option 2.3</b> establishes procedures to ensure that the selection of depositary/third party to whom the custody has been delegated is based on quality and price: this is an additional safeguard against selection bias. In order to make the selection process objective and transparent, the management company will have to document the <i>ex-ante</i> selection criteria, the steps taken in conducting the process, including all meetings, contacts and other interventions that took place in the course of this process.	Additional safeguards result from the fact that records on all contacts relevant in selecting the depositary/third party must be kept after signature of the appointment <sup>57</sup> particulars and must be made available to competent national authorities at any stage while the appointment remains in place <sup>58</sup> .
Group risk	Lower standards in asset segregation if asset manager and depositary have corporate links or belong to the same	<b>Options 1.2 and 2.3</b> rely on avoidance of double membership and a quorum of independent board members plus accompanying corporate governance requirements to minimise the risk that lower standards	Additional safeguards result from the fact that national rules on corporate governance ensure that the views of an independent board member cannot be ignored. Under applicable corporate governance provisions, the views of

<sup>56</sup> All members of the Board of an FCA regulated firm in the UK will have to be approved to carry out controlled functions and will be subject to the **FCA's Statements of Principle and Code of Practice for Approved Persons (APER)**. APER Statement of Principle 4 requires approved persons to "*disclose appropriately any information of which the FCA or the PRA would reasonably expect notice*". A recent French law regarding the fight against tax fraud and financial and economic delinquency (dated of December 6, 2013), grants the whistleblowers' status to any employee or civil servant who "*reported or testified in good faith, facts constituting an offense or a crime of which he was aware in the exercise of its functions*". In implementing UCITS V (Recital 40 and Art. 99d) France intends to provide for an additional and specific framework adapted to the UCITS context.

<sup>57</sup> See, for example, Section 5.2.1.2 of the Luxembourg CSSF's circular 12/546 (regarding the internal organisation of UCITS management companies and self-managed SICAVs) obliging every management company to maintain in an orderly manner records of its activities and its internal organisation. To this end, every management company must put in place "management information" permitting the follow-up of its activity and that of its delegates. This management information must, amongst others, cover risk management, incidents linked to the activity of portfolio management (significant and non-significant NAV errors, breaches of limits, valuation problems, problems of reconciliation, situations giving rise to conflicts of interest and to other problems), execution policy, complaints, minutes of meetings, etc.

<sup>58</sup> See, for example, the UK FCA's general information gathering and investigation powers under Part XI of FSMA 2000 which include the power to require the provision of information (s.165) or to require reports from skilled persons (s.166). Under the FCA Principles for Businesses (**PRIN**) a firm is required to "*deal with its regulators in an open and cooperative way, and to disclose to the appropriate regulator (ie. the FCA) appropriately anything relating to the firm of which that regulator would reasonably expect notice*" (Principle 11). To comply with this Principle, firms are expected to: give representatives or appointees of the appropriate regulator reasonable access to any records, files, tapes or computer systems, which are within the firm's possession or control, and provide any facilities which the representatives or appointees may reasonably request; and produce to representatives or appointees of the appropriate regulator specified documents, files, tapes, computer data or other material in the firm's possession or control as reasonably requested (see SUP 2.3.3G (2) and (3)).

	group. Risk that UCITS investment strategy is not driven by investor interest but by corporate interest of the group to which both the manager and the depositary belong <sup>59</sup>	apply in the group scenario. Governance aims to minimise the risk that the appointment of the depositary is driven by "corporate interest" or that this interest prevails over the interests of UCITS investors (independent oversight that the choice of the UCITS depositary but also the choice of the UCITS investment strategy are taken in the interests of those investors alone).	independent board members have to be recorded in the minutes of the board meeting. The dissenting board member also has the option, and is often obliged, to inform the national competent regulator of his/her concerns (see, e.g., APER principle no 4, cited above).
Conflict of interest due to contractual commitments	Board members without any cross-shareholding or employees links may be still in situation of conflict of interest in case of business link with one of the entity or both of them.	<b>Option 2.3</b> will not only address the problem of conflict of interest within the group inclusion structures but also address the conflict of interest triggered by individual board members' contractual links with the other entity or the group to which both entities belong. .	<b>Option 2.3</b> is complementary to the new rules of Article 25. of the UCITS Directive (i.e. to act honestly, fairly and professionally)

In addition, the analysis in this impact assessment reveals that structural separation by itself risks falling short of addressing other, often more relevant, "channels of influence" in which a group entity or an entity linked by a cross-shareholding can influence the level of investor protection. This impact assessment therefore argues that rules on persons that occupy both entities' governing boards or personal links that exist when board members in one entity have links to the other entity are a more cost effective factor in assessing independent behaviour.

For example, **Option 2.2** does not prevent the possibility of one entity or the group to exert decisive influence by virtue of contracts or by virtue of the ability to appoint affiliated directors or members<sup>60</sup> to the board of the other entity. In light of these shortfalls, addressing potential conflicts of interest by means of structural separation alone is deemed insufficient.

Furthermore, **Option 2.3** focuses on tightening the behavioral standards that govern depositaries/third party to whom the custody has been delegated and management/investment companies that belong to the same group or that are linked by the above-mentioned levels of cross-shareholdings. This option should be considered in conjunction with:

- Article 5 of the UCITS Directive<sup>61</sup> which requires that Member States' competent authorities have to approve the choice of depositary/third party to whom the custody has been delegated.
- Article 18 of the UCITS Directive<sup>62</sup> which requires that management companies to establish implement and maintain an effective conflicts of interest policy<sup>63</sup>.

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<sup>59</sup> Avoiding that UCITS managers are compelled to invest in financial instruments issued by its parent group, e.g., the example of "in-house" total return swaps.

<sup>60</sup> Affiliated members are defined as members of the other entity's management body, the other entity's employees as well as members of the group management body or as employees of the group.

<sup>61</sup> Directive 2009/65/EU

<sup>62</sup> Directive 2010/43/EU

- Article 99 of the UCITS Directive<sup>64</sup> which provides supervisory powers to NCA and the right of Member States to provide for and impose criminal sanctions (administrative sanctions and other administrative measures).
- Article 99 of the UCITS Directive<sup>65</sup> which provides a harmonization on the penalties and the situation when the Member State shall sanction.
- Article 99d of the UCITS Directive<sup>66</sup> which requires that Member State to establish effective and reliable mechanisms to encourage the reporting of potential or actual infringements of national provisions transposing the Directive to NCA.

The behavioral standards as mentioned will provide additional safeguards to ensure investors protection without undue costs of restructuring.

### Efficiency

Although it is difficult to assess how many depositaries and or third parties that hold custody of UCITS assets in the European Union will be impacted (see Annex 5 and Table 6), this impact assessment estimates that those management/investment companies and depositaries/third party delegates that belong to a banking group would be required to transfer a very high percentage (the range is between 94 and 100% in most of the cases) of their assets to a depositary/third party to whom the custody has been delegated, that is not part of the same banking group. Having to "outsource" their entire depositary/custody operations will have immediate repercussions on their ability to continue as depositary or custodian for UCITS assets. Many do not expect to survive as independent depositaries/custodians without the UCITS assets of the 'group' management/investment company.

According to figures provided by ESMA, in terms of assets under management, the necessary reallocation of custodial UCITS assets in the European Union would affect at least €2.5 trillion, which accounts for at least 32% of European UCITS assets.

Moreover, structural separation will have a large impact in individual national markets, especially in small Member States or Member States with smaller UCITS markets, as, on average, 56% of the UCITS assets are held in custody "in-house" across the EU<sup>67</sup>. Operators in smaller Member States face challenges to reallocate assets because of the UCITS requirement that the depositary must be domiciled in the same country of the UCITS: some Member States have only one or two depositaries in their country.

### **Table 6 Asset held in custody impacted by structural separation**

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<sup>63</sup> This article covers also the specific case where the management company is a member of a group. In that case, the policy shall also take into account any circumstances of which the company is or should be aware which may give rise to a conflict of interest resulting from the structure and business activities of other members of the group.

<sup>64</sup> Directive 2014/91/EU

<sup>65</sup> Directive 2014/91/EU

<sup>66</sup> Directive 2014/91/EU

<sup>67</sup> See table 6 in Annex 5.

Member States	AuM in € Million 31/12/2014	Asset held in custody in house 31/12/2014	€ Million	Weighted AVG of the european market impact
Austria	83,553	89%	74,362	1%
Belgium	104,694	71%	74,333	1%
Bulgaria	411	0%	0	0%
Croatia	1,695	86%	1,463	0%
Cyprus	-	-	-	-
Czech Republic	5,984	75%	4,488	0%
Denmark	99,947	32%	31,983	0%
Estonia	-	-	-	-
Finland	71,346	25%	17,837	0%
<b>France</b>	<b>1,145,928</b>	<b>62%</b>	<b>710,475</b>	<b>9%</b>
Germany	296,406	41%	121,526	2%
Greece	4,781	55%	2,630	0%
Hungary	11,416	72%	8,220	0%
Ireland	1,274,477	9%	114,703	1%
Italy	196,299	9%	17,667	0%
Latvia*	171,894	99%	169,659	2%
Lithuania**	2,903	-	-	-
<b>Luxembourg</b>	<b>2,642,504</b>	<b>31%</b>	<b>819,176</b>	<b>11%</b>
Malta	2,903	100%	2,903	0%
Netherland***	62,393	96%	59,897	1%
Poland****	21,708	100%	21,708	0%
Portugal	8,226	98%	8,061	0%
Romania	4,079	79%	3,222	0%
Slovakia	3,445	-	-	-
Slovenia	2,143	0%	0	0%
Spain	225,722	65%	146,719	2%
Sweden	248,930	51%	126,954	2%
United Kingdom	995,340	3%	26,643	0%
<b>Total</b>	<b>7,781,520</b>	<b>56%</b>	<b>2,522,617</b>	<b>32%</b>

*Figures December 2014 have been added to the figure disclosed by EFAMA in their Asset Management in Europe, Facts and Figures December 2014. Figure for Luxembourg has been added to the figure disclosed by EFAMA in their Asset Management in Europe, Facts and Figures December 2014. Figure for Assets held in custody in house based only on incomplete information*

*\*\*\*\* Figure for Assets held in custody in house for end-2013*

*Source: ESMA and EFAMA (information 31/12/2014)*

For example, in Luxembourg, which represents more than €2.6 trillion of UCITS asset under management, 31% of these assets are held in custody in house. This represents more than €819 billion (i.e. 11% of the overall UCITS market). On the other hand, Germany, 41% of the assets are held in custody in-house, but this represents only €121 billion (i.e. 2% of the overall UCITS market). In Latvia, 99% of the assets are held by an in-house custodian; this represents more than €169 billion (i.e. 2% of the overall UCITS market).

The consequences of structural separation will result in the loss of economies of scale for smaller depositaries. As shown in table 6 of Annex 5, a high proportion of the smaller depositaries rely entirely or significantly on their "group" management company to generate the requisite level of economies of scale to maintain viable operations. In consequence, reallocation of assets in the wake of a structural separation will force some of these depositaries to exit the market altogether as small depositaries/third party to whom the custody has been delegated will not be viable without the custody of their "group" management company.

One respondent (a trade association) of the public consultation provided cost estimates of such an asset reallocation as between €80,000 (for a small member) to €2,100,000 (for a large member). In case UCITS assets need to be reallocated to an alternative depositary outside the corporate group, one respondent mentioned that the costs linked to that transfer would range between €150,000 (for a small member) to tens of millions of € (for a large member).

Another depositary estimated that the loss of assets as part of this reallocation due to the structural separation will result in lost synergies amounting to €30,000,000 without being able to specify how much new business this depositary could generate as a result of the asset reallocation. In addition to the figures provided by ESMA, the Commission received confidential information from management/investment company and depositaries/third party to whom the custody has been delegated. The cost of transferring assets to another custodian would be at least comprised €8 million and €13 million for significant players. A smaller player estimated the cost at €2.1 million.

Stakeholders estimate, that a small in-house depositary (< 2 billion in AuM) will have costs of €150,000 to transfer these assets to an independent custodian – assuming that these costs are linear, this results in a cost of roughly €75,000 per €1 billion in assets that have to be transferred. As the asset under custody that will have to be reallocated represent more than €2.5 trillion, the minimum cost of structural separation can be estimated at €187,500 million<sup>68</sup>.

Furthermore, some economies of scale that smaller depositaries currently enjoy on account of their group membership, such as the use of common "group" IT infrastructure, access and operating of IT systems would be lost. This might have an impact on the fees paid by the investors but also on the efficiency of the management/investment company. Under this option, the depositary/third party (to whom the custody has been delegated) but also the management/investment company may not have the same financial capacity underpinning their operation. Without the legal support of the parent company, smaller operators might find it more difficult to comply with increasing regulatory requirements. Consequently, a radical change of depositary/third party (to whom the custody has been delegated) arrangements might have fee implications for UCITS and, indirectly, trigger higher costs for UCITS investors.

All restructuring costs entailed by **Option 2.1** are expected to have an impact in particular on the custody fees that a UCITS management company would need to pay post restructuring. While it is difficult to obtain a clear picture of the different custody and depositary fees structures in each Member State, depositaries that have to restructure their activities in the way described above will certainly wish to pass on these costs to the UCITS management company which, in turn, will pass them onto the UCITS's investors.

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<sup>68</sup> This figure is based on conservative estimate

In these circumstances, and as the industry in many Member States is already highly concentrated, a large scale reallocation of custody assets risks increasing or at least perpetuating the considerable spreads between the minimum and maximum rates for custody services. As it can be seen in table 10 in Annex 5, the depositary fees are, on average, lower in the Member States where the “group” depositary is prevalent. In the same vein, the standard deviation of fees is narrower in those Member States. It seems that having a “group” depositary provide an advantage to investors as the depositary service is cheaper, on account of, E.g., the automation of process that are simpler to implement when depositary and management company rely on the same group IT infrastructure.

In addition to the restructuring costs, management companies and depositaries estimate that implementing structural separation would require between 18 and 24 months. During this time, business focus would be diverted; resulting in missed commercial opportunities for EU domiciled asset managers and depositaries. This would result in a competitive disadvantage of EU operators vis-à-vis their international competitors who would not face this challenge.

On the other hand, it can be noted that 'stand-alone' management companies that do not belong to a banking group would not be affected as they already tend to place their assets into custody with structurally separate international custodians<sup>69</sup>.

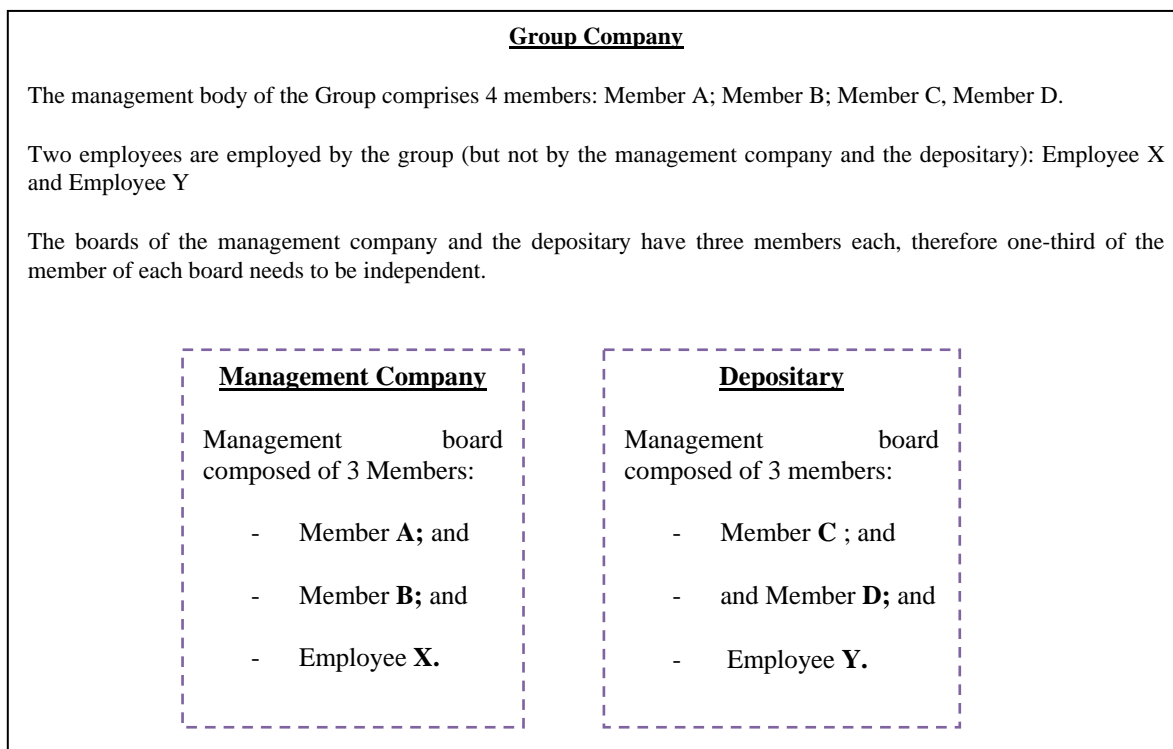
**Option 2.2**, on the other hand, would avoid large restructuring cost and leave in place existing economies of scale. It is therefore expected that this option would have less or no impact on fees that a UCITS management company has to pay to investors.

In order to further limit the costs of **Option 2.2** in the 'group' scenario, this option does not require that all member of either the asset managers' or the depositary's board are independent of their joint 'group' company but establishes a quorum of independent board members. In a 'group' scenario, where the members of the management company's and the depositaries' board are also members of the 'group' board or employed by the group company, **Option 2.2** would only require that at least one-third of the management board of the management company (depositary) has no employment, business or personal links with the group company. Chart 3 provides an example for two boards comprising three members:

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<sup>69</sup> As mentioned above, Blackrock places its UCITS assets in custody with JP Morgan in Ireland (EUR 62 bn), with Bank of New-York Mellon in the United Kingdom and Luxembourg (EUR 146 bn) as well as with State Street (EUR 12bn). Aberdeen, which is managing UCITS assets in France, Luxembourg, the UK and Ireland has custody relations with BNP Paribas Securities Services and State Street to safe-keep EUR 53 bn and EUR 36 bn of assets respectively.

**Chart 3- Example of a group structure with different members in the management body of the depositary and management company but without an independent member.**



In consequence, on the assumption that the annual cost of employing an independent board members amounts, on an EU average, to €1,052<sup>70</sup> (without taking into account the cost of the recruitment process), the overall costs of requiring one-third or two independent board members for the entire EU is estimated to be approximately 3,765 €million<sup>71</sup>.

Despite the efforts to limit cost, this impact assessment concludes that the proposed quorum of one-third or two independent board members is an efficient and effective tool to safeguard independent behavior of both entities' boards. The following considerations are relevant in this respect<sup>72</sup>:

- Most Member States have procedures and rules in place that avoid that the views of an independent board member are ignored. Under applicable corporate governance provisions (see Annex 14 for a detailed overview), the views of independent board member has to be recorded in the minutes of the board meeting. The dissenting board member can require that his/her dissenting views are documented. The dissenting board member also has the option of informing the national competent regulator of his/her concerns. In some instances, there is even a duty to inform the competent regulator of information which the regulator would expect to be apprised of.

<sup>70</sup> See Table 7. Commission service's own calculations on the basis of data submitted by the regulatory authorities of Luxembourg, France, Ireland and the United-Kingdom.

<sup>71</sup> See Table 7, Commission service's own calculations on the basis of data submitted by the regulatory authorities of Luxembourg, France, Ireland and the United-Kingdom which represents more than 80% of the UCITS markets

<sup>72</sup> See Annex 14.

- In addition, documentation and record keeping requirements govern the operation of most company's boards.
- National competent authorities have general information gathering and investigation powers which would comprise the power to require the provision of information or to require reports from company and its officers as well as provide the regulator with access to any records, files, tapes or computer systems, which are within the company's possession or control<sup>73</sup>.
- Depending on the specific circumstances, competent regulators have a variety of intervention powers against asset managers, depositaries or third party custodians that do not comply with the above corporate governance principles. These powers can go up to revocation of a company's authorization, public censure or financial penalties<sup>74</sup>.

The Commission's services have carefully considered ESMA's reasoning and conclude that the proposed rule safeguards that the board of entities that belong to a corporate group contains a sufficient level of independent representation that acts as a counterweight to the "group" members that are represented on both entities' boards. It should be underlined that the non-group representatives' role is to express the interests of UCITS shareholder. An independent voice on the group entities' board appears necessary to counterbalance the corporate interest that is represented by the "group" members on both entities boards. The Commission's services also agree that it is preferable that the non-group representative is not a lone voice on a board whose views will therefore rarely be taken into consideration. Therefore, the rule that there should be at least two independent members on both group entities' boards is also endorsed. It should be point out that this rule entails a risk that, in practice, this rule will be interpreted as stating that two members per board are sufficient, irrespective of the size of a board. To counteract this minimalist interpretation, the Commission's services stress that the rule seeks to have a sufficient quorum of independent members and that group companies should be encouraged to appoint more than two independent board members. Such a choice would express their willingness to listen to and respect a maximum of voices on their respective boards that are not swayed by group interests.

On the other hand, the special situation of small boards should be acknowledged. Should a board comprise less than the average of five to seven members, requiring two independent members might cause additional cost for smaller entities, which usually coincides with having smaller boards. Therefore, the ESMA rule of only requiring one-third of members to be independent from the group appears as a proportionate response. In this context the

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<sup>73</sup> See, for example, **Article 147 of the Luxembourg law of 17 December 2010 on undertakings for collective investment** which allows the competent regulator (the CSSF) to access documents, require any person to provide information and, if necessary, to summon and question any person with a view to obtaining information; carry out on-site inspections or investigations, require communication of the telephone exchanges.

<sup>74</sup> See, for example, **Sections 55J and 55L of the UK Financial Services and Markets Act 2000 (FSMA 2000)** according to which the FCA can vary or cancel the firm's permissions (in the most serious cases) or to impose a requirement on the firm to take, or refrain from taking, a specified action. If appropriate, the requirement could also be published on the FCA's register. Other remedies include: (1) public censure (publication of a statement to inform the public of such contravention) (s.205 FSMA 2000); (2) Financial penalties (s.206 FSMA 2000); (3) Suspension/limitations of the permissions to carry out regulated activities (s.206A FSMA 2000). **Article 147 of the Luxembourg law of 17 December 2010 on undertakings for collective investment** vests the CSSF with powers to withdraw the authorisation granted to an undertaking for collective investment, a management company or a depositary and to transmit information to the Public Prosecutor for criminal proceedings



Commission's services point to the additional cost of having to appoint independent directors - mentioned in particular in Table 7 - that amounts on average to between €10,000 and 30,000 annually. For smaller entities whose boards are limited to three or four members, this would engender additional costs of between €20,000 and €60,000 annually. In light of this burden, the Commission's services agree with ESMA that small boards should only be obliged to have at least one-third of independent directors. Due to downward rounding, this implies that boards of three and four member in total would only need to appoint one independent member.

Table 7 summarizes the research on the cost of independent directors that would need to be appointed in the main fund jurisdictions which represent more than 80% of the UCITS market, as displays in **Option 2.3**. It then compares this cost with an estimate of the cost that **Option 2.2** would entail in these jurisdictions.

The table is based on a series of assumptions<sup>75</sup>:

- National authorities of the relevant fund domiciles delivered estimates of the amount of operators concerned by the rules on additional independent directorships and provided estimates on the overall amount of independent directors that would be required to comply with Option 2.3 (third column) as well as the expected salary cost (fourth column).
- Stakeholders estimate that a small in-house depositary (< 2 billion in AuM) will have costs of €150,000 to transfer these assets to an independent custodian – assuming that these costs are linear, this result in a cost of €75,000/1 billion asset under management.

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<sup>75</sup> This is a conservative estimate.

**Table 7 – Comparison of the costs of appointing independent members with the costs of a structural separation**

Country	<b>Option 2.3:</b> Number of operators affected	<b>Option 2.3:</b> No. of additional directors	<b>Option 2.3:</b> Average Annual cost/independent director (in €)	<b>Option 2.3:</b> Total additional annual cost per country (in €)	<b>Option 2.2:</b> custodial assets to be transferred (in billion €)	<b>Option 2.2:</b> Additional cost per country (in €)
<b>Luxembourg</b>	30 depositaries 47 management companies	104	€30,000	3,120,000	31% = 819 bn	61,425,000
<b>France</b>	25 depositaries	50	€10,000	500,000	62% = 710 bn	53,250,000
<b>Ireland</b>	7 depositaries 7 management companies	<a href="#">None</a> <sup>76</sup>	€20,000	None	9% = 114 bn	8,550,000
<b>United Kingdom</b>	3 management companies	6	€24,208	145,000	3% = 26 bn	1,950
<b>Total</b>			<b>€21,052</b>	<b>3,765,000</b>		<b>125,175,000</b>

Source: Commission service's own calculations on the basis of data submitted by the regulatory authorities of Luxembourg, France, Ireland and the United-Kingdom.

The cost of appointing independent members of the management body of the depositary/third party to whom the custody has been delegated and management company will cost **€3,765 million**. Structural separation, on the other hand, will generate costs of around **€125,175 million**. The appointment of independent members is, therefore, significantly less costly than requiring the structural separation. Although the cost of appointing independent members is an annual cost, this option is still less costly when compared to **Option 2.2**: it will take at least 33 years of remunerating independent directors before the one-off cost of structural separation is reached. In the same vein, the cost of appointing independent members can be mitigated by reducing the number of board members. In consequence, this overall cost of board salaries may actually remain stable.

**Option 2.3** will provide a high standard of investor protection without the significant cost involved in **Option 2.2**. The costs of **Option 2.3** are limited to the annual salaries of independent board members. **Option 2.3** will not create additional administrative costs as the justification of the choice of the depositary, the policy of conflict of interest should already be in place.

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<sup>76</sup> The Irish UCITS regulatory regime currently prohibits UCITS management companies from having any directors in common with their depositaries

**Option 2.3** will provide safeguards not only in the case of conflict of interest arising from the ownership or group inclusion but also in case where the conflict of interest arising from commercial links. For example, whatever the choice of the depositary is, the management/investment company will have to justify its choice. But also **Option 2.3** entails some additional cost, as most of the largest depositary/third party to whom the custody has been delegated, will have to restructure their management body to provide for at least two or one third of independent members. These requirements have not always been met in the past. On the other hand, the requirement to have a minimum of independent members on the management body of the management company/investment company and the depositary/third party to whom the custody has been delegated will provide important safeguards against potential conflicts of interest.

**Option 2.3** emerges as the most effective in protecting investors. **Option 2.3** is also the most efficient in minimising restructuring costs without undermining investor's protection.

**Table 8 - Independence requirement – Corporate links - comparison of options**

	<b>Effectiveness Investor protection</b>	<b>Efficiency Limiting administrative burden</b>
Option 2.2: structural separation	++	--
<b>Option 2.3: corporate governance safeguards for entities that belong to the same group or have cross-shareholdings</b>	++	-

*Magnitude of impact as compared with the baseline scenario: ++strongly positive; + positive; - - strongly negative; - negative; ≈marginal; ? uncertain; n.a. not applicable.*

**Table 9 – Summary of the overall proposal on the independence action.**

In order to differentiate between the situation where management/investment company and depositaries/third party to whom the custody has been delegated, are not in the same group and those that are in the same group, the final policy choice would adopt a three-fold structure:

**Situation A: Management/investment company and depositaries/third party to whom the custody has been delegated are not linked by cross-shareholdings of more than 10% and do not belong to the same group:**

1) No dual membership of the relevant boards of both entities (management and/or supervisory board, as applicable).<sup>77</sup>

**Situation B: Management/investment companies and depositaries/third party to whom custody has been delegated are linked by cross-shareholdings of more than 10% and asset managers and depositaries/third party to whom the custody has been delegated belong to the same group:**

1) No dual membership of the relevant boards of both entities (management and/or supervisory board, as applicable);

<sup>77</sup> An exception is the situation mentioned in **Option 1.2** above (e.g. where the management body is not in charge of the supervisory functions). In that case no more than one third of the members of the body in charge of the supervision shall be a member of the management body or supervisory or an employee of the other entity.

2) Processes for the selection of a depositary shall be documented and be made available to competent authorities to demonstrate that selection of the "group" member is based on objective grounds;

3) Processes to manage the conflicts of interest that may arise out of joint membership of a group or from cross-shareholdings shall be documented and shall be made available to competent authorities.

**Situation C: Special safeguard only for management/investment companies and depositaries/third party to whom the custody has been delegated belong to the same group:**

4) At least one-third or two, whichever is the lesser, of the persons that are appointed to the supervisory board (or the management body where the management board is in charge of supervisory function) of each of the entities shall have no material or personal affiliation with the other entity.

***Table 10 - Overall impact of the preferred options***

	Impacts on investors	Impacts on Asset Managers and depositaries	Impacts on SMEs	Impacts on Financial Stability	Impacts on the EU competitiveness <sup>78</sup>
<b>Option 1.2</b>	(++) Provide the clearest safeguard to ensure independent behaviour of both boards. (++) Reinforce the investor confidence	(-) Restructuring costs due to the appointment of new board members (+) Limitation of the costs in case of dual structure	(+) Reduction of board members can decrease the restructuring costs.	N.A	(+) Neutralisation of additional cost burden, as executive board directors are rarely compensated for their position on a board.  (+) Reduction of board members can decrease the restructuring costs.
<b>Option 2.3</b>	(++) The appointment of independent board members improves overall level of governance and thus investor protection (++) The documentation process on the selection of the depositary is adding more responsibility to the asset managers when it selects its depositary/custodian	(-) Restructuring costs due to the appointment of independent board members	(+) Maintains competition in the depositary/custody markets (+) The costs of appointing independent board member are limited when the board comprises three or less members. (+)Restructuring costs due to the appointment of independent board members is limited to group scenario (+) Many of the governance procedures inherent in this option are already	(+)The depositary market can be seen as being already concentrated. In consequence, the preferred option maintained the statu-quo and does not contribute to reinforce the concentration level of this sector	(+) Reflects international standards, no negative impact on the EU competitiveness.

<sup>78</sup> See Annex 13

			in place and will not create additional administrative burdens for SMEs		
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*Magnitude of impact as compared with the baseline scenario: ++strongly positive; + positive; - - strongly negative;- negative; ≈marginal; ? uncertain; n.a. not applicable.*

## 7. CHOICE OF A LEGAL INSTRUMENT

The Union's right to act is discussed in the impact assessment which accompanied the UCITS V Directive. In sum, the UCITS V aims at providing a clear and consistent framework for the regulation and supervision of UCITS in the EU and at further contributing to the creation of a single European market for UCITS in line with the legal base underpinning EU legislation in this area (Article 53(1) TFEU).

Drawing guidance from these overarching objectives there is a clearly perceived need to have a uniform set of rules binding depositaries, which delegate custody of UCITS assets to third parties or which operate in a setting liable to undermine their independence. This is why instead of relying on a co-existence of different national regulations the Commission was tasked with the adoption of common rules covering all regulatory aspects listed in Annex 10, which are not discussed in this impact assessment.

Most of the UCITS V empowerments, except for Article 25(2) UCITS, to a large extent mirror the provisions on depositaries provided in the AIFMD. Owing to the fact that the delegated act adopted to supplement the AIFMD is a Regulation (Delegated Regulation 231/2013), the rules imposed on UCITS depositaries should be presented in the same legal form in order to ensure the same level of investor protection. There are a number of other good reasons why the Commission should discharge this duty by adopting a Regulation.

First and foremost, a directly applicable legal act would provide all those concerned with a clear set of uniform rules and ensure an effective and comparable level of UCITS investor protection across the Union. This is due to an important advantage of Regulations that they do not require transposition. Directly applicable rules bring an immediate clarity on the legal requirements and substantially contribute to legal certainty.

Secondly, since a Regulation does not require transposition, any future modifications of the regulation would be brought about more quickly than having to wait for transposition of the EU law by national legislators.

It would be effective to discharge the empowerment concerning the 'independent action' laid down in Article 25(2) UCITS in the same legal text. Having all rules applicable to depositaries in the same legal act would contribute to legal clarity for market participants,

Therefore a Regulation seems to be the best instrument for avoiding any possible conflicts of interest between asset managers and their depositaries.

Against these considerations, and taking into account that all other empowerments under UCITS V will be adopted in the form of a Regulation, the Commission services consider a Regulation rather than a Directive to be the most appropriate instrument for defining the meaning of the term “acting independently”.

The legal basis for action at level 2 is provided (and delineated) by the power of the Commission to adopt delegated acts in Article 112a of the UCITS Directive (as amended by UCITS V).

## **6 MONITORING AND EVALUATION**

In its role as the guardian of the Treaties, the Commission's services shall duly monitor Member States' application of the delegated acts adopted under the UCITS Directive. Failing this, the Commission shall pursue Article 258 TFEU against those Member States that fail to fulfil their obligations under the Treaties. The monitoring shall rely on a constant dialogue with Member States through ESMA and with a vast stakeholder network including market participants (i.e. fund management companies, depositaries, and their relative industry associations) and investors via their representative bodies.

It will be necessary to monitor permanently the effects of the Delegated Regulation from its entry into application in order to ensure that everything works smoothly without adverse impacts on specific stakeholders.

Several indicators should be taken into account during the monitoring and evaluation of the level 2 measures such as:

- The number of claims received via the whistleblowing channel or via other channels from board members.
- The number of enforcement procedures and sanctions.
- The number of board members removed.
- The number of time that the national competent authority has used its interventions powers on the specific issues relating to this impact assessment.

In particular achieving of the following objectives is to be monitored:

- ensuring insolvency protection of UCITS assets;
- protecting UCITS investors interest by ensuring that management/investment company and the depositary/ custodian act independently of management/investment UCITS company from the depositary;
- ensuring cross-sectoral consistency.

The evaluation shall be carried out by the Commission's services, in cooperation with ESMA and/or with the aid of external consultants for the purpose of measuring those more specific aspects tied to the application of the regulation. The evaluation shall concentrate its attention on the following aspects in particular:

- Estimate of a depositary's operating costs resulting from the conditions on custody delegation and assess whether the obligations set sufficiently provide consumer protection;
- Estimate of the costs due to the organizational and functional changes of the depositories and management/investment companies carried out in order to ensure that they act independently and whether the set of rules imposed achieve the objective of consumer protection.

## ANNEXES

### Annex 1: Glossary

**Alternative Investment Fund (AIF):** is a legal structure to pool assets and hold investments. It usually has no economic life on its own; the key decisions in relation to the management and marketing of AIF are taken by the AIFM. AIF span a wide range of legal structures, including closed and open-end funds and partnerships.

**Alternative Investment Fund Manager (AIFM):** is responsible for the management of investment portfolios of AIF. Typical tasks include, for example, the provision of internal governance structures, risk management, the delegation of functions to third parties and relations with investors.

**Assets under management:** value of assets that an investment company manages on behalf of investors.

**Centralized securities depository:** an entity that

- 1) enables securities transactions to be processed and settled by book entry
- 2) provides custodial services (e.g. the administration of corporate actions and redemptions)
- 3) plays an active role in ensuring the integrity of securities issues

Securities can be held in a physical (but immobilised) form or in a dematerialised form (whereby they exist only as electronic records)

**Competent authority:** Any organization that has the legally delegated or invested authority, capacity, or power to perform a designated function. In the context of AIFMD, it refers to the body which is in charge of supervising securities markets.

**Custodian:** an entity, often a credit institution, which acts as "account provider" and provides securities custody services to its customers, i.e. holding and administration of securities owned by a third party.

**Depository:** a credit institution that keeps assets or securities on behalf of a client, e.g. an AIF. The depository has two primary functions: to safe-keep the AIF's assets and to oversee its compliance with the AIF rules and with applicable law and regulation.

**ESMA:** The European Securities and Markets Authority is the successor body to CESR, continuing work in the securities and markets area as an independent agency and also with the other two former level three committees. <http://www.esma.europa.eu>

**Liability:** an entity's legal debts or obligations that arise during the course of business operations. Recorded like asset and equity on the balance sheet, liabilities include loans, mortgages or any duty that entails settlement by future transfer.

**Management body:** a body with ultimate decision-making authority in a management/investment company or depository, comprising the supervisory and the managerial functions, or only the managerial function if the two functions are separated. Where, according to national law, the management company, investment company or depository has in place different bodies with specific functions, the requirements laid down in this Directive directed at the management body or at the management body in its supervisory function shall also, or shall instead, apply to those members of other bodies of the management company, investment company or depository to whom the applicable national law assigns the respective responsibility.

**Net Asset Value:** value of a fund's total assets, minus its liabilities. The NAV per share is used to determine prices available to investors for redemptions and subscriptions.

**Safekeeping:** the keeping of assets by a financial institution; the act of holding client's securities or other assets on its behalf.

**Segregation:** a method of protecting a client's assets by holding them separately from those of the custodian (or other clients, as the case may be).

**Settlement:** the completion of a transaction or of processing with the aim of discharging participants' obligations through the transfer of funds and/or securities. A settlement may be final or provisional.

**Sub-custodian:** any company/institution providing custody administration services on behalf of other custodians who may not have an operation in the country concerned.

**Systemic risk:** the risk that the inability of one participant to meet its obligations in a system will cause other participants to be unable to meet their obligations when they become due, potentially with spill over effects (e.g. significant liquidity or credit problems) threatening the stability of or confidence in the financial system. That inability to meet obligations can be caused by operational or financial problems.

**Transferable security:** means classes of securities which are negotiable on the capital market with the exception of instruments of payment.

**UCITS:** Undertakings for Collective Investment in Transferable Securities Directives, a standardised and regulated type of asset pooling.

**Underlying asset:** is a term used in derivatives trading, such as with options. A derivative is a financial instrument whose price is based (derived) from a different asset. The underlying asset is the financial instrument (e.g., stock, futures, commodity, currency or index) on which a derivative's price is based.



## **Annex 2: Short description of the UCITS Directives and scope and timetable of the level 2 work**

### **1. The UCITS Directives**

The UCITS Directive provides for harmonised requirements for entities engaged in the management and marketing of UCITS to investors in the EU. UCITS and their management companies have to be authorised, and in order to obtain this authorisation they have to comply with the requirements of the Directive. Authorisation of a UCITS is granted once the home Member State of a UCITS is satisfied that the requirements on own capital, risk management, investment policies, redemptions, obligation regarding the depositary are satisfied.

The UCITS Directive has amended the UCITS Directive in the areas of depositaries, remuneration policies and sanctions.

Depositaries play a key role in the protection of UCITS investors. They safe-keep the investment assets held by a UCITS, thereby ensuring protection from insolvency or fraud. Depositaries also exercise oversight of the fund operations, including monitoring of a UCITS' cash flows. The UCITS V Directive has clarified and harmonised the depositary functions, the conditions under which delegation can take place, the eligible entities allowed to act as depositaries, and the depositary's liability.

UCITS V contains a variety of empowerments to the Commission pertaining to the strengthened role and liability of depositaries. These empowerments concern the particulars that need to be included in the written contract appointing the third party to whom the safe-keeping functions have been delegated by the depositary, the depositary's oversight duties, its cash monitoring duties, safe-keeping duties, the scope of financial instruments that are to be included within the scope of the depositary's custody duties, due diligence requirements, obligations pertaining to asset segregation, the conditions subject to which and circumstances in which financial instruments held in custody are to be considered to be lost, the definition of an external events beyond reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary related to the liability regime.

All of these issues have already been assessed in the corresponding impact assessment on the depositaries duties and liability that preceded the above-mentioned Delegated Regulation 231/2013. Since the changes related to those issues which will appear in the delegated act adopted to specify certain provisions of UCITS V are rather technical and do not bring about any significant changes they are not discussed in this impact assessment. In addition, these provisions have already been implemented for depositaries in Delegated Regulation 231/2013. As there were no changes afterwards and those measures seem to be efficient at this stage they could be also extended on the UCITS regulation as well with some adjustments where needed. This would ensure consistency between the European regulation regimes by providing a sufficient level of investor protection which is crucial for ensuring safety and trust in the EU funds for retail investors. Taking into account the above, the correlated measures with respect to these empowerment and, where applicable the modifications thereto, are mentioned in Annex 9.

In these circumstances, the present impact assessment can be concentrated on the two additional empowerments contained in UCITS V related to depositary:

- The steps to be taken by the third party to ensure insolvency protection of UCITS assets referred to in point (d) of Article 22a (3) UCITS;

- The conditions for fulfilling the independence requirement referred to in Article 25 (2) UCITS.

## 2. List of delegated acts

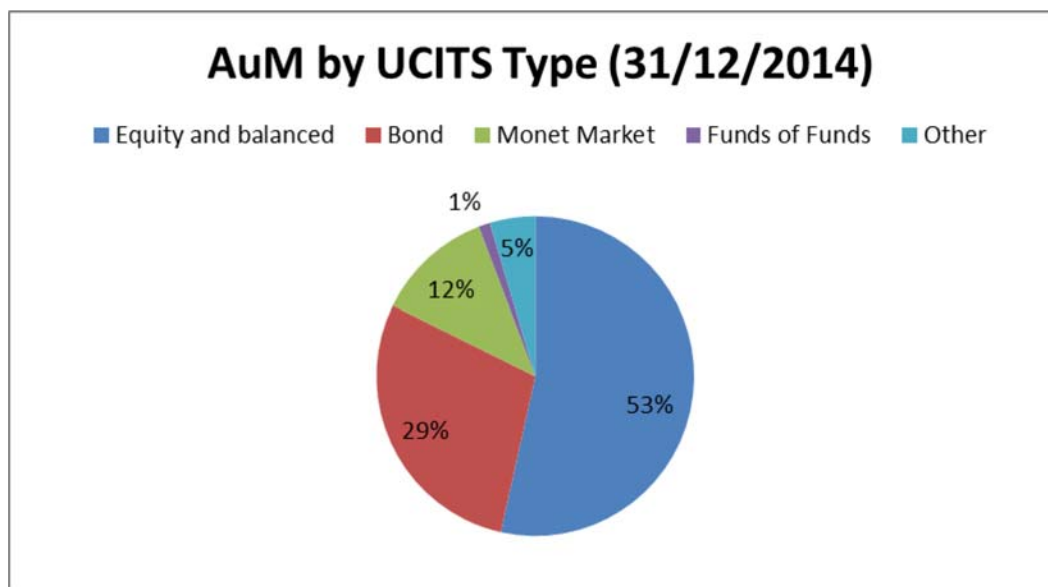
	Article	Description
1	Article 22(2)	The particulars that need to be included in the written contract
2	Article 22(3), (4), (5)	The conditions for performing the depositary functions
3	Article 22a(2)	The due diligence duties of depositaries
4	Article 22a(3)	The segregation obligation
5	Article 22a(3)	The steps to be taken by the third party
6	Article 24	The conditions subject to which and circumstances in which financial instruments held in custody are to be considered to be lost
7	Article 24(1)	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
8	Article 25(2)	The conditions for fulfilling the independence requirement

## 3. (Indicative) Timetable for UCITS V Level 2 work

Date	Milestones
26 June 2014	Commission request for advice to ESMA
29 July 2014	ESMA roundtable of external stakeholders
28 August 2014	UCITS V published in Official Journal, entry into force 17 September 2014
26 September till 24 October 2014	ESMA consultation on draft technical advice (
28 November 2014	Submission of ESMA advice to European Commission
23 April 2015	Consultation of EGESC (Expert Group European Securities Committee)
25 November 2014 till 16 March 2015	European Commission Steering Group
19 May 2015	Submission of IA report to IAB
17 June 2015	IAB meeting
to be completed	Launch ISC
to be completed	Translation
to be completed	Adoption of L2 measures by the College
to be completed	End of period for EP and Council to object to Level 2 measures, MS start implementation of Level 2 Directives
18 March 2016	UCITS V Level 1 and 2 taking effect

### Annex 3: Overview of UCITS sector

**Table 1 - AuM by UCITS Type (September 2014)**



Source: EFAMA: Asset Management in Europe, Facts and Figures, December 2014

The breakdown of investment asset classes has remained relatively constant: equity and balanced funds account for almost 53% of the entire UCITS universe, the remaining funds either fall into the category of bond funds (29%), money market funds (12%) or others.

In terms of number of fund vehicles, the figures translate into 36,148 individual funds at the end of 2014 compared to 35,618 at end December 2013<sup>79</sup>. At the end of 2014, about 80% of UCITS assets are invested by funds domiciled in four jurisdictions: Luxembourg (35.2%), Ireland (17%), France (15.2%), and United Kingdom (13.2%).

UCITS, upon establishment in one Member State, can be marketed to professional and retail investors throughout the EU. Institutional investors, notably pension funds and investment companies, represent the largest client category of the European asset management industry – they account for 76% of total AuM in Europe<sup>80</sup>.

UCITS are managed by management companies<sup>81</sup>. The management companies charge a management fee<sup>82</sup> which is paid out of UCITS assets (i.e. borne by UCITS investors). There are about 1200 UCITS management groups in the EU.

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<sup>79</sup>Source EFAMA Quarterly Statistical Release No 60 (Fourth Quarter of 2014) [http://www.efama.org/Publications/Statistics/Quarterly/Quarterly%20Statistical%20Reports/150311\\_Quarterly%20Statistical%20Release%20Q4%202014.pdf](http://www.efama.org/Publications/Statistics/Quarterly/Quarterly%20Statistical%20Reports/150311_Quarterly%20Statistical%20Release%20Q4%202014.pdf)

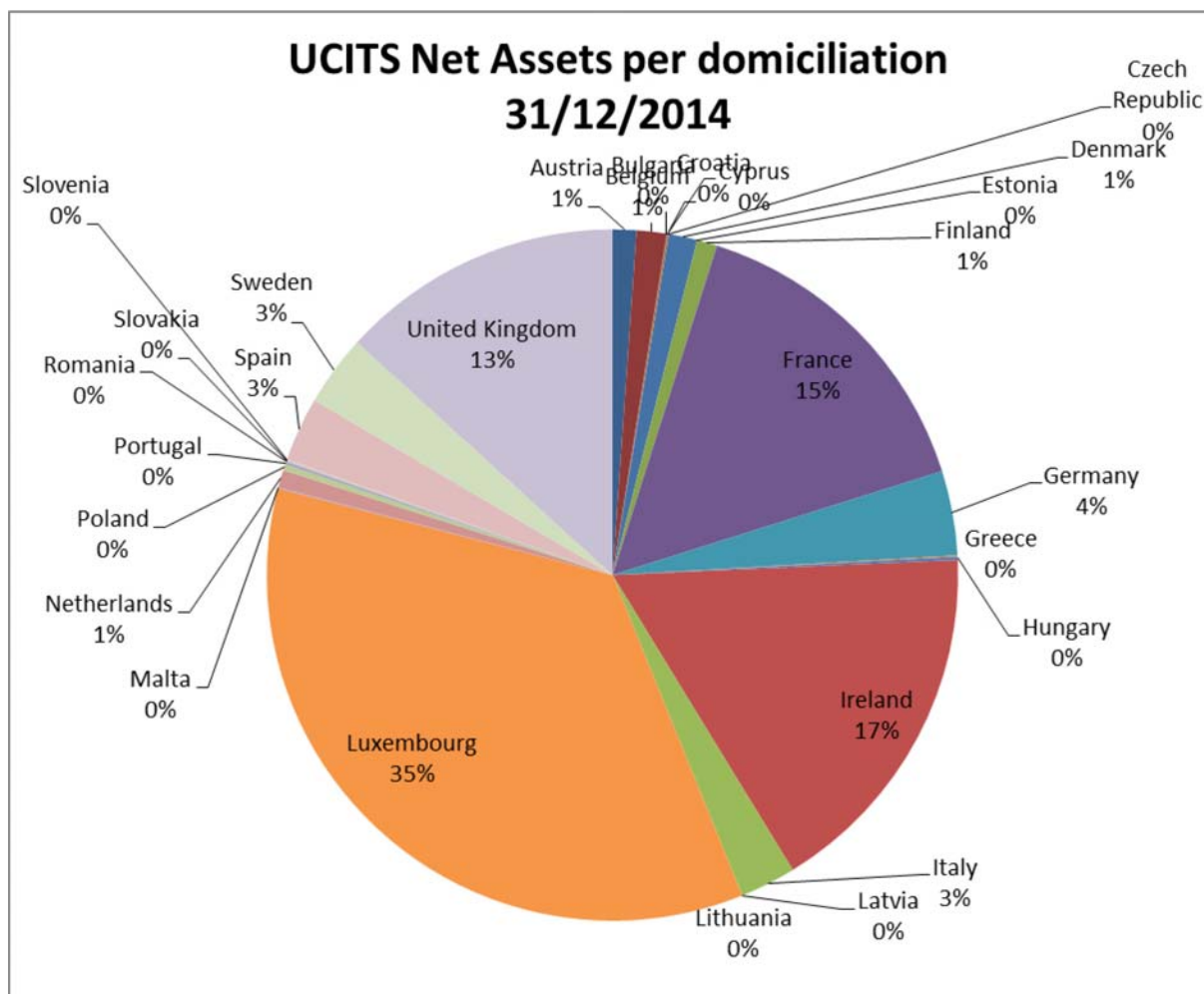
<sup>80</sup> Source: EFAMA: Asset Management in Europe, Facts and Figures, June 2014.

<sup>81</sup> Certain legal forms of UCITS, called investment companies, can be self-managed, i.e. do not have a separate management company.

<sup>82</sup> The management fee is usually fixed percentage of the market value of the assets under management. Some management companies also charge so-called performance fee which is a percentage of profits.

Some management companies are self-standing asset managers while others are part of a banking or insurance group. A management company can be established in one Member State and manage UCITS established in other Member States using the so-called management passport.

**Chart 1 - UCITS Net Assets by Country of Domiciliation Q4 2014**



Source: EFAMA Quarterly Statistical Release No 60 (Fourth Quarter of 2014)

**Table 2 - UCITS Net Assets by Country of Domiciliation Q4 2014**

Net Assets of the European UCITS Industry		
Members	31/12/2014	
	Eur m	share
Austria	83,553	1.1%
Belgium	104,694	1.4%
Bulgaria	411	0.0%
Croatia	1,695	0.0%
Cyprus	-	-
Czech Republic	5,984	0.1%
Denmark	99,947	1.3%
Estonia	-	-
Finland	71,346	0.9%

France	1,145,928	15.2%
Germany	296,406	3.9%
Greece	4,781	0.1%
Hungary	11,416	0.2%
Ireland	1,274,477	17.0%
Italy	196,299	2.6%
Latvia	-	-
Lithuania	-	-
Luxembourg	2,642,504	35.2%
Malta	2,903	0.0%
Netherlands	62,393	0.8%
Poland	21,708	0.3%
Portugal	8,226	0.1%
Romania	4,079	0.1%
Slovakia	3,445	0,0%
Slovenia	2,143	0,0%
Spain	225,722	3.0%
Sweden	248,930	3.3%
United Kingdom	995,340	13.2%
<b>TOTAL</b>	<b>7,514,330</b>	<b>100.0%</b>

Source: EFAMA: Asset Management in Europe, Facts and Figures, December 2014

**Table 3 - UCITS funds per investment area**

	Investment Area	Fund Size EUR bn
	<b>Grand Total</b>	<b>5,714</b>
1	Global	1,952
2	Euroland	1,010
3	United Kingdom	683
4	<b>United States of America</b>	593
5	Europe	434
6	<b>Global Emerging Mkts</b>	348
7	Sweden	96
8	<b>Asia Pacific ex Japan</b>	71
9	Europe ex UK	63
10	<b>Japan</b>	61
11	<b>Asia Pacific ex Japan ex Australia</b>	50
12	Germany	35
13	France	31
14	<b>Asia Pacific</b>	29
15	<b>China</b>	28
16	Denmark	25
17	<b>India</b>	16
18	Italy	16

19	(blank)	16
20	Europe (North)	14
21	<b>Latin America</b>	14
22	<b>Europe Emerging Mkts</b>	14
23	Switzerland	14
24	<b>China (Greater)</b>	13
25	Spain	9
26	<b>Hong Kong</b>	7
27	<b>North America</b>	6
28	<b>Russia &amp; CIS</b>	5
29	<b>BRIC (Brazil, Russia, India and China)</b>	5
30	Other	55

Source: Morningstar, EC staff calculations (June 2014)

## Annex 4 – Depositary's functions

Services offered by depositary's and the independence requirement		
<b>Custody</b> Art. 22(5)	<b>« Core » depositary functions</b> Art. 22(3) (4)	<b>Other activities/services</b>
<u>Can be delegated</u>	<u>Can't be delegated</u>	<u>Not considered as depositary functions under UCITS</u>
<p><b>Independence requirements of Article 25</b></p> <p>Meeting independence requirements of Article 25 is the condition for the delegation of the custody to the third party (Article 22a (3) (e))</p>	<p><b>Independence requirements of Article 25</b></p>	<p><b>functional and hierarchical separation from depositary activities ( Article 25 (2) subpar. 2)</b></p>
<p><b><u>SAFEKEEPING DUTIES</u></b></p> <ul style="list-style-type: none"> <li>- registration of instruments</li> <li>- <u>segregation of accounts and records keeping</u></li> <li>- <u>reconciliation between the depositary's internal accounts and records and those of any third party to whom custody functions have been delegated.</u></li> <li>- <u>due care in relation to the financial instruments held in custody</u></li> <li>- <u>monitoring of the custody risk</u></li> <li>- <u>notification of any risk to ManCo</u></li> <li>- arrangement to minimise the custody risks</li> <li>- verification of the ownership rights of assets</li> </ul> <p>Even in case of delegation of the custody, <b>the depositary remains subject to above mentioned obligations (as underlined)</b> and has to ensure that the third party complies with all above requirements</p> <p>Depositary has to setup an escalation procedure for situations where an anomaly is detected including notification to the UCITS and the competent authorities.</p>	<p><b><u>OVERSIGHT FUNCTIONS</u></b></p> <p><b>General:</b></p> <ul style="list-style-type: none"> <li>- assessment of the risk associated with the UCITS investment strategy and organisation</li> <li>- ex-post control of processes and procedures (verification and reconciliation procedures)</li> <li>- put in place an escalation procedure (for detected irregularities)</li> <li>- access to books and performance of on-site visits</li> </ul> <p><b>subscription and redemptions:</b></p> <ul style="list-style-type: none"> <li>- oversight of UCITS's reconciliation procedures</li> <li>- monitoring of compliance of those rules with national laws and UCITS rules and instruments of incorporation</li> </ul> <p><b>valuation of units</b></p> <ul style="list-style-type: none"> <li>- verification of compliance with laws and rules</li> <li>- notification of irregularities to UCITS ManCo</li> </ul> <p><b>carrying out of the</b></p>	<ul style="list-style-type: none"> <li>• <b>fund accounting,</b></li> <li>• <b>fund administration,</b></li> <li>• <b>transfer agency,</b></li> <li>• <b>foreign exchange management</b></li> <li>• <b>prime brokerage,</b></li> <li>• <b>treasury and securities lending,</b></li> <li>• <b>collateral management,</b></li> <li>• <b>banking services</b></li> </ul> <p><b>investments services under MIFID and ancillary services</b></p>

	<p><b>UCITS's instructions</b></p> <ul style="list-style-type: none"> <li>- monitoring of compliance with investment restrictions and leverage limits</li> <li>- set up an escalation procedure where those rules are breached</li> </ul> <p><b>timely settlement of transactions</b></p> <ul style="list-style-type: none"> <li>- setting up procedures to detect delays in settlements of transactions - request the restitutions of assets from the counterparty</li> </ul> <p><b>UCITS's income distribution</b></p> <ul style="list-style-type: none"> <li>- ensure that the income calculation is in line with laws and rules</li> <li>- ensure a follow-up to the reserves expressed by the auditor</li> <li>- check the completeness and accuracy of dividend payments</li> <li>- notify irregularities to ManCo and ensure remedial action</li> </ul> <p><b>Cash monitoring</b></p> <ul style="list-style-type: none"> <li>- monitoring of all UCITS cash accounts and cash flows</li> <li>- reconciliation</li> <li>- monitoring of significant cash flows (in particular those which could be inconsistent with the UCITS's operations)</li> <li>- review of reconciliation procedures</li> <li>- monitor the outcome of reconciliations and follow-up actions</li> <li>- notify to ManCo all delays in rectifications and to the competent authorities when the situation is not clarified or corrected</li> <li>- check consistency of its</li> </ul>	
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	<p>own records with those of the UCITS</p> <p><b>Payment upon the subscriptions</b></p> <p>- booking of payments upon subscription</p> <p><b>DUE DILIGENCE</b></p> <p>Due diligence duties when selecting a third party to whom a safekeeping functions are delegated</p>	
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## Annex 5: Overview of depositary sector<sup>83</sup>

### The EU market of UCITS depositaries

For each fund recorded by Morningstar, it is possible to identify the depositary. The following table discloses the depositary market structure in each Member State according to their concentration level. The market shares (taking into account the AuM) of each depositary have been computed to get two indicators, the HHI and the top 4 concentration level. Those two indicators are used to measure the degree of competitiveness in a market.

HHI (Herfindahl–Hirschman Index) measures the size of depositaries in relation to the overall industry. It is defined as the sum of the squares of the market shares of the 50 largest depositaries in each market and ranges from 0 to 1. The interpretation is as follows:

**Table 1: Interpretation of HHI ratio**

Range	Concentration
HHI < 0,01	highly competitive index
HHI < 0,15	unconcentrated index
0,15 < HHI < 0,25	moderate concentration
HHI > 0,25	high concentration

The top 4 firm concentration ratio measures the total market share of the four largest depositaries in the market. .

**Table 2 - Concentration ratios of depositary market**

EU Member	Asset held in custody in €	Number of funds	Number of depositaries	HHI	Top 4 concentration
Luxembourg	2,384,985,000	8280	53	0,112	56.84%
Austria	74,634,190	994	25	0,159	68.15%
Spain	139,168,910	1555	37	0,135	65.64%
Germany	225,459,650	1123	52	0,151	73.50%
Italy	189,931,890	695	15	0,205	76.05%
United Kingdom	1,000,735,550	2046	11	0,163	74.60%
Portugal	7,210,910	138	15	0,172	74.64%
Ireland	896,593,520	2028	22	0,171	75.84%

<sup>83</sup> In producing this impact assessment, data has been collected from a variety of different sources. Therefore all conclusions drawn should be treated with an appropriate degree of caution.

Finland	76,549,490	412	11	0,222	79.97%
Belgium	27,068,000	282	16	0,243	84.76%
Denmark	94,855,000	526	17	0,227	80.91%
Slovenia	516,040	124	4	0,299	100.00%
France	645,692,000	2825	31	0,293	85.24%
Poland	3,812,070	33	3	0,351	100.00%
Netherlands	15,980,350	41	5	0,295	95.05%
Malta	1,253,340	24	3	0,521	100.00%
Greece	2,704,540	97	4	0,388	100.00%
Lithuania	153,500	14	3	0,591	100.00%
Sweden	203,603,810	502	3	0,474	100.00%
Estonia	320,630	19	1	1	100.00%
Latvia	44,430	15	2	0,862	100.00%

*Source: Morningstar, Commission own calculation as of December 2014*

It results from the above that, in terms of concentration measured according to the HHI index<sup>84</sup>, the depositary market in EU Member States is relatively concentrated, with the top 4 depositaries accounting for more than 50% in all Member States. In several Member States the top 4 depositaries serve the whole market.

Moreover, the top four depositaries in the major fund domiciles usually comprise the same providers (J.P. Morgan, State Street Bank, Bank of New York Mellon, CACEIS Bank). The predominance of the same providers in all major markets, as well as their global coverage, is an indicator that economies of scale that result from a network of custody spanning several national markets. In addition, the predominance of these four players can be explained by the entry barriers that characterise custody services: strict liability for the loss of financial instruments, capital requirements and the need to establish electronic custody networks. The ECB, in its occasional paper No 68 of August 2007<sup>85</sup> describes the need to perpetually update custodial infrastructure in the following terms:

"Custodian banks must continuously adapt their technology because market practice, industry standards, legal requirements, fiscal processes and infrastructures' procedures and technology are constantly changing. Once the technology investment has been made for a capability, processing additional volumes usually adds limited marginal costs. High fixed costs mean that custodian banks require economies of scale to be profitable".

To remain viable and competitive, depositaries require economies of scale. It is highly likely that a small or medium sized depositary (bank or non-bank depositary) that relies on an asset manager that operates within the same group to achieve the requisite economies of scale could not survive in the marketplace for custody without the economies of scale that the often large percentage of "group" assets provide (cf. table 4 below).

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<sup>84</sup> Herfindahl–Hirschman Index - a measure of the size of firms in relation to the industry and an indicator of the amount of competition among them.

<sup>85</sup> <https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp68.pdf>

Another feature of the depositary market is its long-term trend towards concentration. Already the 2007 ECB Occasional Paper identified this trend towards consolidation which is characterised by two drivers: (1) almost no new entrants to the custody business within the decade preceding 2007 and (2) the exit of a number of single-market and global custodian banks from the provision of depositary and/or custody services. As the ECB states in its occasional paper:

"This trend is expected to continue worldwide; custodian banks with insufficient scale economies will find it increasingly difficult to compete. Global custodians compete in a concentrated market segment. In 2005 the top 10 global custodians held 77% of the securities in this market segment, reflecting consolidation which started in the 1990s and is expected to continue. The recently announced merger between Bank of New York Mellon is an illustration of the high level of concentration in the US market, which is dominated by four players. In 2005, half of the securities held at global custodians were with US providers, reflecting mostly the size of their home market but also their increasing market share in the rest of the world. The largest European global custodian is ranked in fifth place. Consolidation of the global custody industry in Europe, encouraged by conditions created after the introduction of the euro and the single passport for financial services, and by competitive pressure from US providers, is expected to continue."

The accuracy of the ECB prognosis is borne out by developments in the different Member States. For example, the developments in Germany between 2000 and 2013 brought a wave of consolidation in the depositary sector:

- 2002: State Street takes control of Deutsche Bank's custody activities
- 2002: BNY takes control of BHF Bank and WestLB's custody branches
- 2007: CACEIS takes control of the custody operations of HypoVereinsBank (HVB)
- 2013-14: BayernLB and NordLB are expected to divest their custody operations
- 2013: Commerzbank announces the sale of its custody operations to BNP Paribas Securities Services<sup>86</sup>

As a result the top 4 custody providers in Germany (State Street, BNP Paribas Securities Services, DZ Bank and Deka Bank) control over 73% of the assets held in custody in that jurisdiction, a concentration level comparable to the US market described by the ECB Occasional Paper.

Luxembourg appears the only national market where the top four providers do not yet control 60% of the assets, but even in Luxembourg their consolidated market share is 56.84%.

As a general rule, the tables above also reveal that the Member States with the highest number of AuM tend to display lower levels of concentration in their depositary markets. One exception to this is France, the fourth largest market in terms of assets held in custody. Despite its large amount AuM, France ranks among the highly concentrated depositary markets. The overall trend across Europe is toward an increase in concentration.

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<sup>86</sup> Reported in AGEFI HEBDO of 12 September 2013.

These is reflecting in the Table 3, that shows that in average top 4 concentration is relatively high in Europe.

**Table 3 - Average HHI and Average top 4 concentration ratio for all national depositary markets in the Union**

	<b>Average HHI</b>	<b>Average top 4 per country concentration ratio</b>
Non weighted	0,334	85.29%
Weighted according to the AuM per country	0,1715	69.75%

*Source: Commission own calculations as of December 2014.*

The difference between the two average measures is explained by the weight of Luxembourg which has the highest number of AuM as well as the lowest degree of concentration. However both figures indicate that the European market as a whole is fairly concentrated.

**Table 4 - List of largest UCITS custodians and Country coverage by custodian (as of December 2014)**

<b>Ranking</b>	<b>Custodian</b>	<b>AuM in €bn</b>	<b>Market share</b>	<b>Country coverage</b>
<b>1</b>	<b>State Street</b>	<b>959,361</b>	<b>16.01%</b>	<b>8</b>
<b>2</b>	<b>JPM</b>	<b>794,321</b>	<b>13.26%</b>	<b>7</b>
<b>3</b>	<b>Bank of New York Mellon</b>	<b>620,228</b>	<b>10.35%</b>	<b>5</b>
<b>4</b>	<b>CACEIS</b>	<b>408,888</b>	<b>6.83%</b>	<b>4</b>
<b>5</b>	<b>BNP Paribas Securities Services</b>	<b>405,431</b>	<b>6.77%</b>	<b>9</b>
6	BBH	340,189	5.68%	3
7	RBC	223,485	3.73%	6
8	Societe Generale	198,674	3.32%	6
9	Citi	195,357	3.26%	3
10	Northern Trust	164,458	2.75%	3
11	National Westminster	138,615	2.31%	2
12	HSBC	130,760	2.18%	5
13	DZ Bank	109,540	1.83%	2
14	UBS	93,792	1.57%	4
15	SEB	69,219	1.16%	8
16	Nordea	59,376	0.99%	3
17	DekaBank	58,842	0.98%	2
18	Pictet	54,152	0.90%	1
19	Banque Fédérative du Crédit Mutuel	43,198	0.72%	1
20	Fideuram	37,682	0.63%	1
21	Santander	34,059	0.57%	1

22	Credit Suisse	32,906	0.55%	3
23	Cecabank S.A.	30,040	0.50%	1
24	Svenska Handelsbanken	28,266	0.47%	2
25	Raiffeisen Bank	22,359	0.37%	1
26	Danske Andelskassers Bank AS	20,677	0.35%	1
27	Banque de Luxembourg	19,480	0.33%	1
28	Banca Popolare Italiana Soc. Coop.	17,227	0.29%	1
29	Erste Group Bank AG	15,882	0.27%	1
30	Banco Depositario BBVA S.A.	15,689	0.26%	1
31	CM-CIC Securities	14,754	0.25%	1
32	Banque Degroof	13,221	0.22%	1
33	KBL	12,977	0.22%	1
34	Edmond de Rothschild (France)	12,412	0.21%	1
35	Banque et Caisse d'Épargne de l'Etat	11,000	0.18%	1
36	KBC	10,950	0.18%	1
37	BANCA POP DELL'EMILIA ROMAGNA Soc. Coop.	10,816	0.18%	1
38	Oddo & Cie	9,956	0.17%	1
39	Banque Privée Edmond de Rothschild	9,667	0.16%	1
40	Bankinter S.A.	7,796	0.13%	1
41	Union Bancaire Privée	7,560	0.13%	1
42	Lazard Frères Banque	7,447	0.12%	1
43	Hauck & Aufhäuser	7,439	0.12%	3
44	UniCredit Bank Austria AG	7,047	0.12%	1
45	Sal. Oppenheim	6,974	0.12%	2
46	KAS	6,920	0.12%	2
47	Nykredit Bank A/S	6,841	0.11%	1
48	M.M. Warburg	6,477	0.11%	2
49	BANCA POPOLARE DI SONDRIO s.c.p.a.	6,153	0.10%	1
50	SwissLife Banque Privée	6,013	0.10%	1
		<b>5,990,755</b>	<b>92.22%</b>	

Source: Morningstar, Commission own calculation as of December 2014.

***Table 5 – Explanation of the difference in term of AuM***

In Mio EUR	Total UCITS AuM in € million (Morningstar 12/2014)	Total UCITS AuM in € million (EFAMA 12/2014)	Statistical difference
<b>Austria</b>	74,634	83,553	<b>-10.67%</b>
<b>Belgium</b>	27,068	104,694	<b>-74.15%</b>
<b>Bulgaria</b>	-	411	<b>n/a</b>
<b>Croatia</b>	-	1,695	<b>n/a</b>
<b>Cyprus</b>	-	-	<b>n/a</b>
<b>Czech Republic</b>	-	5,984	<b>n/a</b>
<b>Denmark</b>	94,855	99,947	<b>-5.09%</b>
<b>Finland</b>	76,549	71,346	<b>7.29%</b>
<b>France</b>	645,692	1,145,928	<b>-43.65%</b>
<b>Germany</b>	225,460	296,406	<b>-23.94%</b>
<b>Greece</b>	2,705	4,781	<b>-43.42%</b>
<b>Hungary</b>	n/a	11,416	<b>n/a</b>
<b>Ireland</b>	896,594	1,274,477	<b>-29.65%</b>
<b>Italy</b>	189,932	196,299	<b>-3.24%</b>
<b>Latvia</b>	171,894	-	<b>n/a</b>
<b>Lithuania</b>	2,903	-	<b>n/a</b>
<b>Luxembourg</b>	2,384,986	2,642,504	<b>-9.75%</b>
<b>Malta</b>	1,253	2,903	<b>-56.84%</b>
<b>Netherlands</b>	15,980	62,393	<b>-74.39%</b>
<b>Poland</b>	3,812	21,708	<b>-82.44%</b>
<b>Portugal</b>	7,211	8,226	<b>-12.34%</b>
<b>Romania</b>	-	4,079	<b>n/a</b>
<b>Slovakia</b>	-	3,445	<b>n/a</b>
<b>Slovenia</b>	516	2,143	<b>-75.92%</b>
<b>Spain</b>	139,169	225,722	<b>-38.34%</b>
<b>Sweden</b>	203,604	248,930	<b>-18.21%</b>
<b>United Kingdom</b>	1,000,736	995,340	<b>0.54%</b>
<b>TOTAL</b>	<b>6,165,553</b>	<b>7,514,330</b>	<b>-19.53%</b>

According to figures provided by ESMA, in terms of assets under management, the necessary reallocation of custodial UCITS assets in the European Union would affect at least €2.5 trillion, which accounts for at least 32% of European UCITS assets.

Moreover, structural separation will have a large impact in individual national markets, especially in small Member States or Member States with smaller UCITS markets, as, on

average, 56% of the UCITS assets are held in custody "in-house" across the EU<sup>87</sup>. Operators in smaller Member States face challenges to reallocate assets because of the UCITS requirement that the depositary must be domiciled in the same country of the UCITS: some Member States have only one or two depositaries in their country.

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<sup>87</sup> See table 6 in Annex 5.



**Table 6 - Overview of the use of in-house depositaries by the management companies belonging to a banking group (December 2014)**

Asset Manager	in house Depositary	Group	AuM in € million	Proporti on within group	AUM within the group	UCITS assets held in custody by the depositor y	Proportio n of the assets in custody held by depositor y within in house manager Asset Manager
Aberdeen Asset Management	NA	NA	89,006	0%	NA	NA	NA
AllianceBernstein	NA	NA	44,791	0%	NA	NA	NA
Allianz Invest Kapitalanlagegesellschaft mbH							
Allianz Global investors Europe	Allianz Investmentbank	Allianz Group	102,858	3%	3,085	3,570	86%
Allianz Global investors							
Allianz popular Investor							
Anima Asset Management	NA	NA	29,594	0%	NA	NA	NA
Aletti Gestielle SGR	Banco Popolare Soc. Coop.	Banco Popolare	13,286	96%	12,754	17,212	74%
Amundi	CACEIS	Credit Agricole	156,616	95%	148,629	408,888	36%
ARCA SGR	ICBPI	Consortium of Italian Banks	21,268	100%	21,268	21,268	100%
Arquigest, SGIIC	Caja de Arquitectos SCC	Caja de Arquitectos	73,066	100%	73,066	73,066	100%

Aviva Investors	NA	NA	51,141	0%	NA	NA	NA
AXA Investment Managers	NA	NA	80,272	0%	NA	NA	NA
Banco Madrid Gestion de Activos SGIIC	Banco De Madrid, S.A	Banca Privada D'Andorra, SA	1,935	35%	0,677	0,677	100%
Banif Gestao de Activos	Banif-Banco de Investimento, SA	Banif	0,139	100%	0,139	0,139	100%
Bankia Fondos, SGIIC S.A.	Bankia S.A.	Bankia	5,563	100%	5,563	5,563	100%
3 Banken-Generali Inv.-Gesellschaft mbH	Bank für Tirol and Vorarlberg AG	3 Banken Gruppe & Generali Holding Vienna AG	3,250	100%	3,250	6,535	50%
	BKS Bank AG						
	Oberbank AG						
Bankinter Gestion de Activos, S.A. SGIIC	Bankinter S.A.	Bankinter	5,878	100%	5,878	7,476	79%
Banque de Luxembourg Investments	Banque de Luxembourg	Banque de Luxembourg	7,326	100%	7,326	19,480	38%
Bansabadell Inversion S.A. SGIIC	Banco de Sabadell S.A.	Banco de Sabadell	0,539	100%	0,539	0,966	56%

Barclays Wealth Managers Espana / France/ Portugal	Barclays Bank S.A.	Barclays Bank	16,676	12%	2,001	2,064	97%
Barclays fund & advisory							
Barclays multimanager funds							
<b>BAWAG PSK Invest</b>	<b>BAWAG AG</b>	<b>BAWAG</b>	<b>3,294</b>	<b>100%</b>	<b>3,294</b>	<b>3,352</b>	<b>98%</b>
Bayerninvest	Bayerische Landesbank	Sparkassen	2,159	2%	0,043	0,107	40%
<b>BBVA Asset Management S.A., SGHIC</b>							
<b>BBVA Gest</b>	<b>BBVA, S.A</b>	<b>BBVA</b>	<b>14,180</b>	<b>100%</b>	<b>14,180</b>	<b>15,690</b>	<b>90%</b>
Blackrock (Luxembourg)			108,256	0%			
Blackrock advisors (UK)	NA	NA	2,382	0%	NA	NA	NA-
Blackrock asset management (Ireland)			47,595	0%			

Blackrockfund management				50,672	0%				
BlueBay Funds Management Company S.A.	NA		NA	28,667	0%	NA	NA	NA	NA
<b>BNP Paribas Asset Management</b>	<b>BNP Paribas Securities Services</b>	<b>BNP Paribas</b>		<b>185,000</b>	<b>99%</b>	<b>183,594</b>	<b>405,431</b>	<b>47%</b>	
<b>BNP Paribas Gestion de Inversiones</b>									
<b>BNP Paribas Investment Partners Lux</b>									
<b>BNP Paribas Investment Partners SGR</b>									
<b>BNPP IP Belgium SA</b>									
<b>THEAM</b>				<b>8,014</b>	<b>100%</b>	<b>8,014</b>			

BNY Mellon Service KAG	The Bank of New York Mellon SA/NV, Asset Servicing, Niederl. Frankfurt am Main	Bank of NY Meelon	82,321	41%	33,752	620,228	5%
BNY Mellon Asset Management							
BNY Mellon Funds Management							
BPI Gestao de Activos	Banco BPI S.A.	BPI	1,018	100%	1,018	1,018	100%
Caixagest	Caixa Geral de Depositos, SA	CGD	2,211	100%	2,211	2,211	100%
Caja Espana fondos, SGIIC	Banco de Caja Espana De Inversiones	Unijaca Banco	1,181	100%	1,181	1,181	100%
Unigest	Salamance Y Soria, S.A						
	Unicaja Banco, S.A						
Caja ingenieros gestion, SGIIC	Caja de Credito de Los ingenieros, S.coop	Caja De Creditos De Los Ingenieros	0,237	100%	0,237	0,237	100%
Caja laboral gestion, SGIIC	Caja laboral popular coop.DE credito	Caja laboral popular	0,228	100%	0,228	0,228	100%
Carmignac Gestion	NA	NA	47,650	0%	NA	NA	NA
CM-CIC Asset Management	Banque Fédérative du credit Mutuel	Crédit Mutuel	43,134	100%	43,082	43,198	100%

<b>Credito Agricola Gest</b>	<b>Caixa Central de Credito Agricola Mutuo, Crl</b>	<b>CCCAM</b>	<b>0,370</b>	<b>100%</b>	<b>0,370</b>	<b>0,370</b>	<b>0,370</b>	<b>100%</b>
<b>Crédit agricole Mercagestion, SGIIC</b>	<b>Bankoa,S.A.</b>	<b>Caisse Regionale de Credit Agricole / Mutuel Pyrenees Gascogne</b>	<b>0,239</b>	<b>100%</b>	<b>0,239</b>	<b>0,239</b>	<b>0,239</b>	<b>100%</b>
<b>Crédit suisse gestion SGIIC</b>	<b>Credit suisse AG,SE</b>	<b>Crédit Suisse</b>	<b>25,967</b>	<b>97%</b>	<b>25,188</b>	<b>32,906</b>	<b>77%</b>	
<b>Danske Invest Management</b>	<b>Danske Bank</b>	<b>Danske Bank</b>	<b>49,493</b>	<b>35%</b>	<b>17,323</b>	<b>20,677</b>	<b>84%</b>	
<b>Danske Capital</b>								
<b>Danske fund of funds</b>								
<b>Dansk invest</b>								
<b>Deka Investment Gmbh</b>	<b>Deka Deutsche Girozentrale</b>	<b>Deka Bank</b>	<b>58,970</b>	<b>96%</b>	<b>56,611</b>	<b>58,842</b>	<b>96%</b>	
<b>Deka International</b>								
<b>Degroof fund Management Company</b>	<b>Banque Degroof</b>	<b>Degroof</b>	<b>13,451</b>	<b>100%</b>	<b>13,451</b>	<b>13,451</b>	<b>100%</b>	
<b>Bank Degroof</b>								
<b>Banque Degroof Luxembourg</b>								
<b>Deutsche Bank asset management</b>	<b>Deutsche Bank</b>	<b>Deutsche Bank</b>	<b>144,179</b>	<b>2%</b>	<b>2,884</b>	<b>5,212</b>	<b>55%</b>	
<b>DWS Investments</b>								
<b>Dimensional Fund Advisors</b>								
<b>Eurizon Capital</b>	<b>NA</b>	<b>NA</b>	<b>11,654</b>	<b>0%</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	
<b>Erste Sparinvest KAG</b>	<b>Ersts Group Bank AG</b>	<b>NA</b>	<b>92,945</b>	<b>0%</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	
<b>Erste Asset Management</b>	<b>Erste &amp; Steriemärkische</b>	<b>Erste Group Bank</b>	<b>14,488</b>	<b>100%</b>	<b>14,475</b>	<b>15,882</b>	<b>91%</b>	

SAI Erste	BCR Bank							
Fidelity Investments	NA	NA	118,261	0%	NA	NA	NA	NA
<b>Fideuram Gestions SA</b>	<b>Fideuram Bank Lux</b>	<b>Fideuram Bank</b>	<b>27,193</b>	<b>94%</b>	<b>25,673</b>	<b>37,682</b>	<b>68%</b>	
FIM Varainhoito Oy	FIM Bank	FIM Bank	3,940	30%	1,185	1,219	97%	
Franklin Templeton Investments	NA	NA	136,945	0%	NA	NA	NA	
Generali Investments Europe	NA	NA	20,817	0%	NA	NA	NA	
<b>Gescooperativo, SGIC</b>	<b>Banco cooperativo Espanol, S.A</b>	<b>Banco Cooperativo</b>	<b>1,641</b>	<b>100%</b>	<b>1,641</b>	<b>1,641</b>	<b>100%</b>	
<b>Gestifonsa, SGIC</b>	<b>Banco Caminos,S.A.</b>	<b>Banco Caminos, S.A.</b>	<b>0,255</b>	<b>100%</b>	<b>0,255</b>	<b>0,566</b>	<b>45%</b>	
Goldman Sachs Asset Management International	NA	NA	93,586	0%	NA	NA	NA	
<b>Gutmann Kapitalanlage AG</b>	<b>Bank Gutmann AG</b>	<b>Bank Gutmann</b>	<b>2,177</b>	<b>100%</b>	<b>2,177</b>	<b>2,869</b>	<b>76%</b>	
<b>Helaba Invest</b>	<b>Landesbank Hessen-Thüringen Girozentrale</b>	<b>Sparkassen</b>	<b>2,290</b>	<b>100%</b>	<b>2,290</b>	<b>2,290</b>	<b>100%</b>	
Henderson Investment Funds Ltd. Henderson Management S.A.	NA	NA	49,069	0%	NA	NA	NA	
<b>HSBC Global Management</b>	<b>HSBC Trinkaus &amp; Burkhardt AG</b>	<b>HSBC Group</b>	<b>75,860</b>	<b>53%</b>	<b>40,206</b>	<b>130,760</b>	<b>31%</b>	
<b>HSBC trinkaus investment manager</b>	<b>HSBC Bank PLC</b>	<b>HSBC Group</b>						

HSBC investment funds	HSBC Bank PLC	HSBC Group					
Ibercaja Gestion, SGIIC	Ibercaja Banco, S.A.	Ibercaja	4,942	1%	0,050	0,070	71%
ING investment management (belgium)	ING BANK	ING BANK	0,435	50%	0,218	1,818	93%
ING investment management (Luxembourg)			32,400	0%	0,000		
ING TFI S.A			1,470	100%	1,470		
Insight Investment	NA	NA	39,660	0%	NA	NA	NA
Inverseguros Gestion, SGIIC	Inverseguros SV, S.A	Inverseguros	0,437	100%	0,437	0,437	100%
Invesco	NA	NA	102,977	0%	NA	NA	NA
Inversis Gestion, SGIIC	Banco inversis, S.A.	Banca March	3,178	97%	3,090	3,604	86%
March Gestion de Fondos SGIIC S.A.	Banco March S.A						



<b>JP Morgan Asset Mgmt (Europe)</b>	<b>JP Morgan Bank Lux</b>	<b>JP Morgan</b>	<b>224,599</b>	<b>100%</b>	<b>224,599</b>	<b>794,321</b>	<b>28%</b>
<b>JP Morgan Asset Mgmt (UK)</b>	<b>JP Morgan Chase Bank</b>						
<b>Kutxabank Gestion SGIIC S.A.</b>	<b>Kutxabank S.A.</b>	<b>Kutxabank</b>	<b>5,940</b>	<b>100%</b>	<b>5,940</b>	<b>5,940</b>	<b>100%</b>
<b>KBC Asset Management NV</b>	<b>KBC Bank NV</b>	<b>KBC Group</b>	<b>18,172</b>	<b>61%</b>	<b>10,950</b>	<b>10,950</b>	<b>100%</b>
<b>La Française AM</b>	<b>NA</b>	<b>NA</b>	<b>1,373</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>
<b>Landesbank Berlin Investment</b>	<b>Landesbank Berlin</b>	<b>Landesbank Berlin</b>	<b>2,574</b>	<b>28%</b>	<b>0,729</b>	<b>0,729</b>	<b>100%</b>
<b>LBBW</b>	<b>Landesbank Baden-Württemberg Wüstenrot Bank AG</b>	<b>Sparkassen</b>	<b>3,829</b>	<b>93%</b>	<b>3,561</b>	<b>3,82</b>	<b>93%</b>
<b>Legal &amp; General Investment Management</b>	<b>NA</b>	<b>NA</b>	<b>56,768</b>	<b>0%</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>
<b>Legg Mason</b>	<b>NA</b>	<b>NA</b>	<b>18,173</b>	<b>0%</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>
<b>Mapfre Inversion Dos, SGIIC</b>	<b>Mapfre Inversion SV, S.A</b>	<b>Mapfre</b>	<b>1,785</b>	<b>100%</b>	<b>1,785</b>	<b>1,785</b>	<b>100%</b>
<b>Mediolanum Gestion, SGIIC</b>	<b>Banco Mediolanum, S.A</b>	<b>Mediolanum</b>	<b>6,263</b>	<b>100%</b>	<b>6,263</b>	<b>11,404</b>	<b>55%</b>
<b>Meriten Investment Management</b>	<b>The Bank of New York Mellon SA/NV, Asset Servicing, Niederl. Frankfurt am Main</b>	<b>The Bank of New York Mellon</b>	<b>0,309</b>	<b>11%</b>	<b>0,033</b>	<b>0,621</b>	<b>5,31%</b>
<b>Metzler Investment</b>	<b>B. Metzler seel. Sohn &amp; Co. KGaA</b>	<b>Metzler</b>	<b>2,301</b>	<b>91%</b>	<b>2,091</b>	<b>2,091</b>	<b>100%</b>

MFS Investment Management	NA	NA	22,402	0%	NA	NA	NA	NA
M&G Investments	NA	NA	86,757	0%	NA	NA	NA	NA
Millennium BCP Gestao de Activos	Banco Comercial Português, SA	millennium BCP	1,057	100%	1,057	1,057	1,057	100%
Montepio Gestao de Activos	Caixa Economica Montepio Geral	Montepio	0,246	95%	0,233	0,233	0,233	100%
Morgan Stanley Investment Management	NA	NA	55,230	0%	NA	NA	NA	NA
Natixis Asset Management	Bred Banque Populaire	BPCE	64,007	1%	0,640	3,885	3,885	16%
NORD/LB	NORD/LB Norddeutsche Landesbank Girozentrale	Sparkassen	0,907	100%	0,907	1,026	1,026	88%
Nordea Invest	Nordea Bank	Nordea Bank	83,833	70%	58,683	59,000	59,000	99%
Nordea funds company								
Novo banco Gestion, SGIIC	Novo Banco, S.A.,SE	Novo Banco	0,724	100%	0,724	0,724	0,724	100%
Nykredit portefølje administration	Nykredit	Nykredit	3,675	100%	3,675	6,841	6,841	54%
Pictet Funds	Pictet & Cie	Pictet	42,304	97%	41,179	54,152	54,152	76%
PIMCO	NA	NA	77,535	0%	NA	NA	NA	NA
Pioneer Investments Austria GmbH	UniCredit Bank Austria	Gruppo UniCredit	115,707	6%	6,942	7,047	7,047	99%



Santander Asset Management S.A., SGHC	Santander Investment S.A.							
Santander Private Banking Gestion S.A. SGHC	Santander Investment S.A.							
Schroders	NA	NA	123,893	0%	NA	NA	NA	NA
SEB Investment Management AB	SEB AB							
SEB Funds Services	SEB AB	SEB AG	41,972	100%	41,972	69,519	60%	
SEB Wealth Management	AS SEB Banka							
SSGS KAG	Société Générale	Société Générale S.A.	43,036	96%	41,314	198,674	21%	
Societe Generale Gestion								
Société générale Private Wealth management								
BRD AM								
Etoile Gestion								
Lyxor Asset Management								
Standard Life Investments	NA	NA	81,731	0%	NA	NA	NA	NA

State Street Global Advisors	State Street	State Street	37,898	100%	37,898	959,361	4%
Threadneedle Investments	NA	NA	32,947	0%	NA	NA	NA
UBS Third Party Mgmt	UBS	UBS	88,962	98%	86,782	93,792	93%
UBS Global AM GmbH							
UBS Gestion							
UBS Fund Management SA							
UBS Gestion, SG IIC							
Union Investment Luxembourg	DZ Bank	DZ Bank Group	42,471	100%	42,471	109,540	79%
Union investment privatfonds Luxembourg			47,204	92%	43,673		
Union Bancaire Privée		Union Bancaire Privée	6,599	96%	6,335	7,560	84%
Universal-Investment	NA	NA	16,383	0%	NA	NA	NA
Vanguard	NA	NA	41,873	0%	NA	NA	NA
Warburg Invest	M.M. Warburg & CO KGaA	M.M. Warburg	1,492	100%	1,492	6,477	23%
Wellington Management Company	NA	NA	11,057	0%	NA	NA	NA
<b>TOTAL</b>			<b>4,132,881</b>	<b>54%</b>	<b>1,496,470</b>	<b>4,464,240</b>	<b>34%</b>

Source: Morningstar, EC staff calculations as of December 2014

- Bank and non-bank depositaries

**Table 7- Non exhaustive list of non-Bank depositaries**

Non-bank depositaries	Countries	AuM in Eur million
SEI Trustee & Custodial Services	EI	9,720
Stichting Bewaarder Robeco	NL, LU	5,999
St,Bewaarder Fortis Beleggingsfondsen NL	NL	2,222
Universal-Investment Luxembourg S,A,	LU	2,109
Mapfre Inversion Sociedad de valores, S,A	ES	1,785
Stichting Bewaarder TIGfund	NL	1,702
Inverseguros, SVB, S,A,	ES	0,438
Financière Meeschaert	FR	0,397
Interfi	FR	0,283
Oudart SA	FR	0,239
Portigon Financial Services	DE	0,178
NLB Skladi	SL	0,126
COGEFI	FR	0,116
Stichting Bewaarbedrijf Ohpen	NL	0,089
Financière d'Uzès	FR	0,052
Seligson & Co Rahastoyhtiö Oyj	FI	0,051
ALIZEE Investment AG	AT	0,045
ACA Sociedad de Valores	ES	0,036
Internationale KAG mbH	LU	0,022
Leleux Associated Brokers S,A,	BE	0,022
<b>TOTAL</b>		<b>25,631</b>

Source: Morningstar, Commission own calculation 31 December 2014,

Most depositaries operating in Europe are authorised as a credit institution. They are therefore subject to all prudential and regulatory requirements applying to banks. Non-bank depositaries (table above) do, however, account for a small portion of the market. In comparison to the banks, those depositaries tend to have significantly fewer assets in custody and, with a single exception, operate in a single Member State only. The ECB's analysis of the future business strategies to be adopted by such "single market" depositaries points out that these operators, in order to remain viable, have to either extent their custody networks or, should their market position weaken, "decide whether to continue investing and competing for external clients to at least break even on the fixed costs, or to exit the custody business and find a service provider to support their affiliates' needs"<sup>88</sup>,

<sup>88</sup> ECB, Occasional Paper No 68, p. 21

Indeed most of the asset managers favor the biggest depository service providers because of their global network of custodians. This is because irrespective of the place of investment the asset manager is assured that the depository will delegate custody of assets to sub-custodians that belong to the same group. Custodian services provided within the global network may come at a more attractive price than it could be negotiated by the depository with an independent custodian domiciled in the jurisdiction of investment.

***Table 8 - Overall markets (UCITS & AIFs) where global custodians offer direct custody***

Custodian	Europe	Asia	Americas	Africa	Middle East	Total
BNP Paribas Securities Services	17	4	N/D	2	N/D	23
BNY Mellon	5	0	3	0	0	8
Citi	N/D	N/D	N/D	N/D	N/D	61
HSBC Securities Services	7	18	4	1	10	40
JP Morgan	N/D	N/D	N/D	N/D	N/D	0
Northern Trust	2	0	2	0	0	4
RBC Investor & Treasury Services	2	0	1	0	0	3
SGSS	18	1	N/D	3	N/D	22
State Street	N/D	N/D	N/D	N/D	N/D	N/D

Source: Global custody survey – September 2014

***Table 9 - Overall markets (UCITS & AIFs) where global custodians offer custody via sub-custodians***

Custodian	Europe	Asia	Americas	Africa	Middle East	Total
BNP Paribas Securities Services	19	15	11	19	11	75
BNY Mellon	30	20	13	24	8	95
Citi	N/D	N/D	N/D	N/D	N/D	33
HSBC Securities Services	29	1	5	13	2	50
Northern Trust	38	16	10	25	12	101
RBC Investor & Treasury Services	37	18	9	11	9	84
SGSS	17	15	8	6	6	52
State Street	N/D	N/D	N/D	N/D	N/D	103

Source: Global custody survey- September 2014

- Cost of custody in different Member States

Spreads in depositary rates (especially the spreads between the minimum and maximum rates) between Member States are often considerable.

In an effort to shed some light into the depositary fee structures, the Directorate General for the Internal Market and Services, in 2006, commissioned a study on cost structures that prevail in the asset management sector.

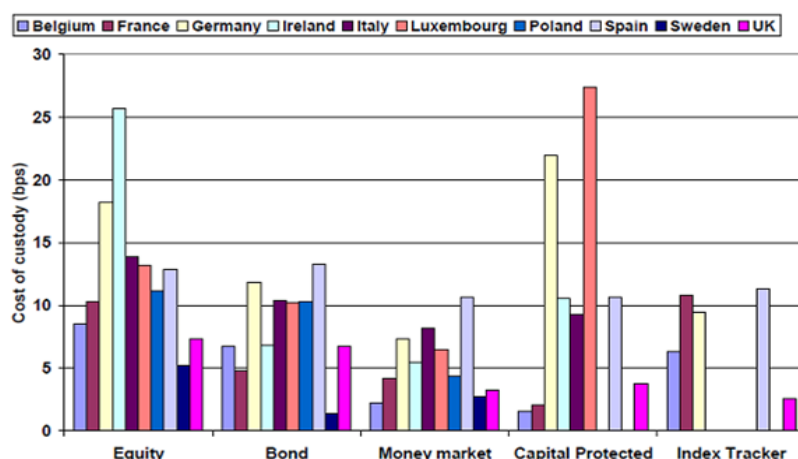
The cost of custody services depends on how these services are remunerated. Typically, their payment schedule is set out in a 'rate-card' negotiated with the fund manager which includes a holding fee based on the value of the assets being 'held' in custody, as well as a transaction fee. Additional elements affecting the cost of such services are the categories of the assets held by and the size of the fund. Research demonstrates that costs are highest for small funds that specialize in equity, followed by those with a focus in bonds. Custody costs are lowest for money market funds.

The costs all tend to converge once funds reach a 'critical' size (i.e., > €100-150 million of assets held in custody), suggesting that economies of scale may be reaped above certain thresholds.

A regression analysis revealed that there are sizeable differences across countries on the costs of custody, even after accounting for fund size. For example, compared to Belgium, custody fees are lower in France, the UK, and Sweden (although the coefficient for Sweden is not significant) and higher in Germany, Spain and Italy,

These differences translate into significant differentials in overall average costs (in terms of basis points) paid by funds for custody services across relevant sample of EU countries as depicted by the graph below.

**Chart 1 – Overall average costs paid by funds for custody services across relevant sample of EU countries**



Source: *Potential cost savings in a fully integrated European investment fund market*, CRA International (September 2006),



The above trend of pricing heterogeneity in cost of custody between Member States as could be also observed in the overall costs of the depository services which typically comprise custody and oversight costs (see: Table 10).

***Table 10- Spreads in depository rates (%)***

in bps	Average	Min	Max	Standard Deviation
Germany	1,29	0,90	1,93	0,42
Belgium	1,62	0,82	2,81	0,90
UK	2,69	0,90	3,83	0,98
Netherlands	1,25	0,62	2,59	0,78
Italy	1,34	0,90	2,02	0,47
Spain	1,28	0,90	1,78	0,38
France	1,1	0,74	1,49	0,31
<b>Total</b>	<b>1,51</b>	<b>0,83</b>	<b>2,35</b>	<b>0,61</b>

*Source: PWC figures submitted to the EC by Union Investment*

The depository charges fees<sup>89</sup> for the safe-keeping services which is paid from the UCITS assets (i.e, borne by UCITS investors). Management companies that do not belong to a banking group typically use several of different depositaries (for different funds they manage) while the management companies that belong to a banking group with an in-house depository capacity tend to appoint an in-house depository for the entire range of their funds.

The selection of a depository or a custodian is based on costs, the quality of services rendered and security of assets. However, in recent years, transparency and security requirements for the depositaries have grown because of regulatory changes (mainly the introduction of the AIFMD) as well as increased awareness of custody risk by customers. In addition, the UCITS V Directive reinforces the liability and duties of the UCITS's depository/third party and prohibits the reuse of assets on its own account.

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<sup>89</sup> The custody fee is calculated as a percentage of the market value of the assets that are held in custody.

## **Annex 6: Steps to ensure insolvency protection of UCITS assets**

### *Problem drivers*

UCITS funds are allowed to invest in any third country of the asset managers' choice. Investments in a large range of countries all over the world are reflective of many UCITS and their investment strategies. However in some of jurisdictions either practical considerations or local legal requirements may impose the necessity to have recourse to the services of a local custodian to safe-keep financial assets that are issued in these jurisdictions. In such cases a depositary may choose to delegate its safe-keeping functions to this third party domiciled outside the EU.

### *Problem*

Lack of clarity on what happens to UCITS assets held in custody by a third party can lead to the following issues:

- Investors are not protected against the insolvency of a local custodian who has received a delegation to safe-keep UCITS assets;
- Investors may not be sufficiently apprised of custody risk associated with investments in third countries;
- The sharing of responsibility in regards of the steps to be taken to ensure that UCITS assets are not distributed to the benefit of a local custodian are not always sufficiently clear.

### *Consequence*

The above situations could have adverse impacts on consumer protection, financial stability and transparency of the functioning of the capital markets. The lack of clarity would leave discretion to UCITS management companies, depositaries and National Competent Authorities to assess whether UCITS management/investment companies and depositaries ensure that third party takes all necessary steps to ensure that in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among, or realisation for the benefit of, creditors of the third party. This could definitely result in a lack of harmonisation in the application of the provisions of the UCITS Directive across different Member States and also to diminish the confidence of the investors in the UCITS regulation. This is an action that should be done ex-ante in order to prevent any kind of unexpected consequence in case of insolvency of the third party or any other third party to whom the custody has been delegated.

This is why, article 26b (e) empowers the Commission to adopt delegated acts specifying the steps to be taken by the third party pursuant to point (d) of Article 22a (3) UCITS. This provision constitutes an add-on in comparison to rules applicable to the depositaries under AIFMD. It foresees that one of the strict conditions for the safekeeping functions to be delegated to the third party is that the depositary can ensure that that third party, at all times during the performance of the tasks delegated to it 'takes all necessary steps to ensure that in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among, or realisation for the benefit of, creditors of the third party'.

In fact, two requirements in UCITS are important when assessing whether custodial assets are protected against insolvency of a custodian: (1) the requirement to ensure that UCITS's assets are protected against the creditors' claims in case of the custodian's insolvency as laid down in Article 22a (3)(d) UCITS and, (2) the requirement to segregate the UCITS' assets as required under Article 22a(3)(c)<sup>90</sup>.

The objective of this empowerment is to protect UCITS assets in case of a third party's insolvency. Therefore this requires that depositaries exercise due diligence in selecting and appointing the third party to whom safekeeping is delegated. This is the rationale underpinning Article 22a(2)(c) UCITS. This means that all necessary efforts should be made to verify that insolvency laws and relevant jurisprudence in the jurisdiction of the delegate recognise the segregation of the UCITS' assets and that assets of UCITS are unavailable for distribution among, or realisation for the benefit of, creditors of the third party in case of its insolvency. There is a case for this requirement to be as close as possible to the corresponding provision in Delegated Regulation n° 231/2013, which, in its Article 98 (2) (a) states that the depositary has to, at least, assess the regulatory and legal framework, including country risk, custody risk and the enforceability of the third party's contract to enable it to determine the potential implication if an insolvency of the third party for the assets and rights of the fund. Furthermore, the depositary is obliged to periodically review and monitor the custody risks, in accordance with Article 98 (3) (c). That assessment shall be based on information provided by the third party and other data and information where available<sup>91</sup>. ESMA's advice however suggests that the depositary should make all reasonable effort, including the receipt of legal advice from a natural or legal person not affiliated to the depositary, to understand the material effect of the contractual provisions governing the arrangement with the third party on the UCITS' rights in respect of its assets, including how those contractual provisions would operate in the jurisdiction where UCITS assets are held, including in the event of insolvency of the third party to which the depositary has delegated safekeeping duties. This additional requirement complements the due diligence duties which are already established in Article 98 (2) (a) of Regulation n° 231/2013,

With respect to the empowerment under Article 26b (e) UCITS, ESMA recommends on a series of steps that should be taken by the local custodian, to ensure protection of UCITS assets in case of insolvency of the third party in order to specify Article 22a (3) (d). These steps include: information to the depositary on applicable insolvency laws, maintenance of the updated records and accounts of UCITS assets and their regular disclosure to the depositary, management of custody and operational risks, advice on legal effects and enforcement of pledges any other operations on assets in the third country. The drafting of this duties will align with UCITS Directive and fit to provisions which will be adopted along the lines of the Regulation n° 231/2013 (see Annex 9).

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<sup>90</sup> For the sake of consistency it is important to note that level 2 provisions supplementing these requirements need to be aligned with Article 99(1)(a) of the Delegated Regulation n° 231/2013 provides for an explicit requirement for the third parties to whom the safekeeping functions have been delegated to segregate assets of the depositary's AIF clients from its own assets, assets of its other clients, assets held by the depositary for its own account and assets held for clients of the depositary which are not AIFs.

<sup>91</sup> This requirement will be therefore specified with respect to the due diligence requirement incumbent on the delegating depositary in accordance with Article 22a (2) (c) and in application of the empowerment in Article 26b (c) UCITS.

Furthermore, ESMA's advice proposes a solution on how the delegating depositary can obtain a clear and up-to-date view on the insolvency laws and jurisprudence that govern insolvency in the jurisdiction of the third party in order to ensure compliance with Article 22(a)(3)(d). This will introduce legal clarity on how the depositary is able to meet its due diligence and monitoring obligations.

In specifying the steps to be taken by the third party in accordance with Article 22(a)(3) (d), which a delegating depositary has to check and monitor. ESMA identifies a core issue: who is best placed to provide the legal advice on the insolvency laws applicable in the third country's jurisdiction?

ESMA suggests that the third party, located outside of the EU, obtains a legal advice on country risk and custody risk to UCITS assets in case of insolvency of a third party from a person not affiliated to the third party to whom safe-keeping functions are to be delegated. This option rests on the premise that only a third party that is independent of both the depositary and the custodian in receipt of delegation can be relied on to provide an objective and unbiased picture on the insolvency laws and jurisprudence in the country in which the third party is located. The rationale is that only a non-affiliated/non commercially dependent legal adviser can be trusted to make a fair and honest assessment of the key issue which is whether segregation of assets is robust enough to withstand a custodian's insolvency.

The level 2 provisions have to impose a direct obligation on depositary to ensure that this obligation is met. This can be done by means of its contractual arrangement with the third party. The suggested solution has the advantage of clarity regarding the integrity of the legal advice received by the depositary. Legal advice obtained from non-affiliated entity ensures the best available safeguard that this advice is objective and unbiased and thus provides the best available safeguards to UCITS investors, especially UCITS retail investors. This option is also best in avoiding conflict of interests that could arise out of the fact that the provider of the advice is in an employment relationship with the organisation or entity that has requested the advice or the concerned third party which has an economic interest in providing the delegated safe-keeping services. This option will boost the due diligence obligation of the depositary in comparison to the analogical provisions of AIFMD level 2. It should not however affect the liability regime laid down in UCITS which is imposed on depositary.

### **Impacts on stakeholders (e.g., consumers, asset managers, depositaries, custodians)**

The requirement to obtain legal advice from a non-affiliated person will provide additional protection to investors and especially retail investors as they do not have the expertise and the resources to appreciate the finer points of applicable insolvency regime in the countries where investment assets are kept in custody.

However, even professional investors that participated in the ESMA stakeholder consultation have mentioned that obtaining independent legal advice on custody risks in countries, in which they have business partners, is reflective of current market practice. Indeed, it is already a standard practice today for depositaries and global custodians to seek for legal advice on insolvency rules applicable in third country jurisdictions where mutual fund assets are held in custody with a view of obtaining comfort as to what reasonable steps need to be taken in order to protect clients' assets. In consequence, this means that such legal advices already exist for almost all jurisdictions where UCITS assets are invested and held in custody. However, those existing legal advice may be obliged to be redrafted in order to respect the requirement of the UCITS directive. In consequence, marginal costs may appear.

Obtaining legal advice from non-affiliated entity is not expected to adversely impact small or medium sized custodians. Smaller custody organisations would invariably have to have recourse to external lawyers as they are unlikely to have these capacities in-house. In consequence, a uniform requirement that stipulates that all legal advice on applicable insolvency provisions has to be provided by an independent source is expected to level the playing field between large and smaller custody providers.

In addition, in order to reduce the cost for the industry to have a legal advice from an independent legal adviser, it should not be prohibiting to mutualise the costs of these advices. For example, European association or national associations may play an active role in order to mutualise the costs. These advices may be offered by the association in exchange of the contribution of their members. According to the market practise the cost of a legal advice will depend on many different factors such as:

- Jurisdiction for which such advice is being sought (Is there a clear rule of law, available jurisprudence, etc.). The interest for this jurisdiction will also have in impact on the costs<sup>92</sup>.
- Different categories of assets covered by the advice (equities, fixed income instruments, other types of financial instruments).
- Reputation and credibility of the independent firm providing such legal advice.

Depending on those factors, the estimate cost of such legal advice could range from €5,000 to €15,000. So sharing these costs via depositary associations, custodian associations or banking association will significantly decrease the costs per entity. Another alternative to pool the legal advice will be to use the ISDA model. The ISDA model in another context has proven to be a successful way of mutualising the costs, while, at the same time, ensuring a high level of consistency and quality of the legal opinions made available and updated on a regular basis.

These possibilities will contribute to not increase the costs for industry but also the costs paid at the end by the investors.

Unlike to receive the advice from non-affiliated party, the option consisting to receive the advice from an 'in house' legal department of the asset managers, depositaries/third party or to the parent company of both parties (the 'in-house' option) should not be considered as providing enough safeguards to investors. The 'in house' option suffers from the fact that the advice is provided by a person who is in an employment relationship with the recipient of the advice or the third party to whom the safe-keeping functions are to be delegated. Pressure to render a more favourable view than the view objectively merited cannot, in these circumstances, be entirely excluded. The conflict of interest inherent in relying on an in-house legal opinion is prone to produce a more biased outcome. This could ultimately result in investor detriment.

Other parts of the ESMA's advice which go beyond the list of steps the third party has to take during the performance of the safe-keeping tasks which have been delegated to it are disregarded insofar they go beyond the empowerment in Article 26b(e) UCITS. Some parts of

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<sup>92</sup> For example, a legal advice on the US could be cheaper as there is more potential client willing to buy this legal advice rather than in a small country where the investment opportunities are narrow.

advice are also already covered by the due diligence duties and will be adopted in implementation of the empowerment in Article 26b(c).

This said other than changes required by legal drafting or consistency sake, we do not deviate from the ESMA's advice regarding this issue and therefore there is no need for the further impact assessment.

***Table 1: Steps to ensure insolvency protection of UCITS assets - comparison of options – Legal advice options.***

	Effectiveness Investor protection	Efficiency Limiting administrative burden
Option 1: legal advice from a non-affiliated entity	++	+
Option 2:'in house' legal advice	-	≈

*Magnitude of impact as compared with the baseline scenario: ++strongly positive; + positive; - - strongly negative;- negative; ≈marginal; ? uncertain; n.a. not applicable.*

## **Annex 7: How problems could evolve with regard to the various issues – Madoff case**

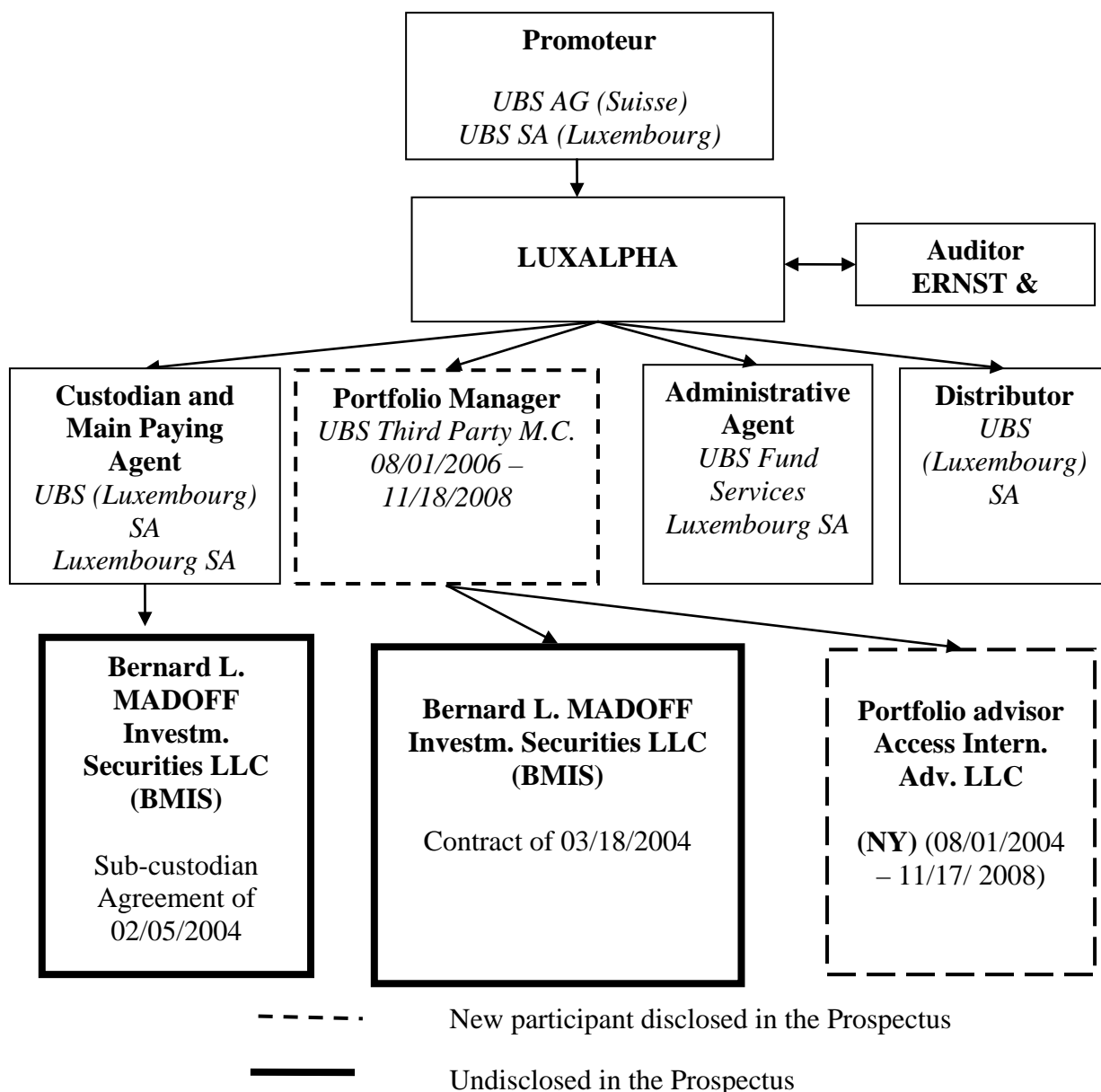
In the LUXALPHA case<sup>93</sup>, the portfolio management was ensured by UBS Third Party M.C from 08/01/2006 to 11/18/2008. However, this entity has delegated their portfolio management to an entity named Bernard L, MADOFF Investment Securities LLC (BMIS). Furthermore, the custodian activity has been ensured by UBS (Luxembourg) SA who has entirely delegated to Bernard L, MADOFF Investment Securities LLC (BMIS) the custody of some assets.

The large scale of the Madoff fraud essentially went undetected for a long period because the depositary responsible for the safekeeping of the fund assets delegated custody over these assets to the same entity run by Bernard Madoff to which the management of investments was delegated. This has been reinforced by the fact that the information regarding the delegation has not been disclosed to investors.

The chart below shows the structure of the delegation structure in the Luxalpha case:

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<sup>93</sup> Source: UBS assignment of proceeds by the fund's liquidators – 18 December 2009



In the aim to avoid a large scandal as Madoff, the delegated act must clarify the level 1 to ensure the depositary or the third party to which the custody has been delegated has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks and the potential conflicts of interest are properly identified, managed and monitored and disclosed to the investors of the UCITS. In addition, the due diligence duties of depositaries when it selects and appoints a third party located inside or outside the European should be specified as also the steps that the third party should put in place to verify that the applicable insolvency laws and jurisprudence recognise the segregation of the UCITS' assets from the third party's own assets and from the assets of the depositary.

Without any specification, the requirements in the UCITS Directive, would leave discretion to UCITS management companies, depositaries, third parties and national competent authorities to determine the necessary steps that shall be taken to ensure that in the event of insolvency of a third party, assets of a UCITS held by the third party in custody are unavailable for



distribution among or realisation for the benefit of creditors of the third party. This could clearly lead to a lack of harmonisation in the application of the provisions of the UCITS V Directive across the UCITS investment industry on a very sensitive issue.

In the same vein, the same issue appears regarding the due diligence duties of depositaries in the selection of a third party.

Undoubtedly, uncertainty on the due diligences duties in the selection of a third party and on the steps considered as being necessary and on the measures to be taken by the depositary and the third party could lead to a situation where some Member States would adopt stricter rules than others on these two issues, leading to greater uncertainty for investors of UCITS in the different Member States who would not know to what extent the assets of the UCITS they invest in are protected. For instance, a depositary could be considered as failing to meet the above-mentioned requirements in one Member State and therefore be allowed to safeguard the assets of a UCITS. This would be particularly problematic in the context of the EU passport of the UCITS Directive but also to ensure the robustness of the UCITS model.

Consequently, without action a Madoff scenario will still remain possible.

## **Annex 8: A practical example outlining the independence requirement between the depositary and the fund's management company as applicable in the UK**

Primary legislation in the UK requires the fund's depositary and its management company to be independent of each other,<sup>94</sup> This rule applies to each type of UCITS, i.e. irrespective of its chosen legal form.

To note: UCITS may be constituted in accordance with contract law (as common funds managed by management companies), trust law (as unit trusts), or statute (as investment companies). In the UK, UCITS may be established as unit trusts (AUTs), investment companies with variable capital (ICVCs) or authorised contractual schemes (ACS). For ICVCs, the independence requirements are set out in the OEIC Regulations<sup>95</sup>, for ACS they are contained in section 261D (4) and for AUTs in section 243(4) of the Financial Services and Markets Act<sup>9697</sup>. To take the specifics of each legal fund structure into account, the requirements are all phrased slightly differently. However, in substance they all mean the same thing: the UCITS management company and its depositary have to be independent of each other.

The UK FCA is providing Guidance to further qualify their understanding of the notion of "independence". They have identified at least three different kinds of possible links between a UCITS management company and its depositary: these relate to common directors, cross-shareholdings and contractual arrangements. In detail:

### **a) Influence by directors:**

In the FCA's view, independence is likely to be lost if, by means of executive power, either party could control the action of the other one. This means that the board of one party should not be able to exercise effective control over the other board. Such arrangements could relate to quorum provisions and reservations of decision-making capacity of certain directors.

The concept of common directors relates to an employee holding simultaneously directorships on both boards. In addition and due to its corporate structure, the director of an ICVC is deemed to be dependent if he has a direct or indirect shareholding for investment purposes of more than 0,5% of the votes at a general meeting of the ICVCs depositary. Any other relationship with the [depositary](#) which exposes the director to a potential conflict of interest questions his independence even further.

### **b) Influence by shareholdings:**

Independence is likely to be lost if either of the relevant parties could control the actions of the other one by means of shareholders' votes, The [FCA](#) considers this would happen if any

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<sup>94</sup> [http://www.legislation.gov.uk/ukxi/2001/1228/pdfs/ukxi\\_20011228\\_en.pdf](http://www.legislation.gov.uk/ukxi/2001/1228/pdfs/ukxi_20011228_en.pdf)

<sup>95</sup> Regulation 15(8)(f) of the OEIC Regulations requires: " The person appointed as the depositary of the company must be independent of the company and of the persons appointed as directors of the company."

<sup>96</sup> "The operator and the depositary must be persons who are independent of each other."

<sup>97</sup> "The manager and the trustee must be persons who are independent of each other."

shareholding by one party and their respective [associates](#) in the other exceeds 15% of the voting [share](#) capital. However, the [FCA](#) is willing to look at cross-shareholdings exceeding 15% on a case-by-case basis to consider if there were exceptional grounds for concluding that independence was safeguarded by other means.

c) Contractual commitments:

The [FCA](#) encourages relevant parties to consult it in advance about its view on the consequences of any intended contractual commitment or relationship which could affect independence, whether directly or indirectly.

## **Independence of depositaries and scheme operators**

COLL 6,9,2 G

(1) Regulation 15(8)(f) of the OEIC Regulations (Requirements for authorisation) requires independence between the depositary, the ICVC and the ICVC's directors, as does section 243(4) of the Act (Authorisation orders) for the trustee and manager of an AUT, and section 261D(4) of the Act (Authorisation orders) for the depositary and authorised fund manager of an ACS2, COLL 6,9,3 G to COLL 6,9,5 G give the FCA's view of the meaning of independence of these relationships, An ICVC, its directors and depositary or a manager and a trustee of an AUT or an authorised fund manager and depositary of an ACS2 are referred to as "relevant parties" in this guidance.

(2) There are at least three possible kinds of links between the relevant parties:

- (a) directors in common;
- (b) cross-shareholdings; and
- (c) contractual commitments.

(3) If any of these links exist between the relevant parties, the FCA will have regard to COLL 6,9,3 G to COLL 6,9,5 G in determining whether there is independence.

## **Independence: influence by directors**

COLL 6,9,3 G

(1) Independence is likely to be lost if, by means of executive power, either relevant party could control the action of the other.

(2) The board of one relevant party should not be able to exercise effective control of the board of another relevant party. Arrangements which might indicate this situation include quorum provisions and reservations of decision-making capacity of certain directors.

(3) For an AUT or ACS2, the FCA would interpret the concept of directors in common to include any directors of associates of one relevant party who are simultaneously directors of the other relevant party.

(4) For an ICVC, independence would not be met if:

(a) a director of the ICVC or any associate of the director is a director, an employee, or both of the depositary; or

(b) a director of an ICVC:

(i) has a direct or indirect shareholding for investment purposes of more than 0,5% of the votes at a general meeting or a meeting of holders of the class of share concerned of the depositary of that ICVC; or

(ii) has any other relationship with the depositary which might reasonably be expected to give rise to a potential conflict of interest.

### **Independence: influence by shareholding**

COLL 6,9,4 G

Independence is likely to be lost if either of the relevant parties could control the actions of the other by means of shareholders' votes. The FCA considers this would happen if any shareholding by one relevant party and their respective associates in the other exceeds 15% of the voting share capital, either in a single share class or several share classes. The FCA would be willing, however, to look at cross-shareholdings exceeding 15% on a case-by-case basis to consider if there were exceptional grounds for concluding that independence was safeguarded by other means.

### **Independence: contractual commitments**

COLL 6,9,5 G

The FCA would encourage relevant parties to consult it in advance about its view on the consequences of any intended contractual commitment or relationship which could affect independence, whether directly or indirectly.

**Annex 9: Comparison of the UCITS Directive and AIFM Directive on Depositary rules (Eligible Entities and discharge of liabilities)**

	UCITS Directive	AIFMD
Eligible Entities	Article 23	Article 21,3
	<p>The depositary shall be:</p> <p>a) a national central bank</p> <p>b) a credit institution authorised in accordance with Directive 2013/36/EU; or</p> <p>c) another legal entity, authorised by the competent authority under the law of the Member State to carry out depositary activities under this Directive, which is subject to capital adequacy requirements not less than the requirements calculated depending on the selected approach in accordance with Article 315 or 317 of Regulation (EU) No 575/2013 of the European Parliament and of the Council <sup>(24)</sup> and which has own funds not less than the amount of initial capital under Article 28(2) of Directive 2013/36/EU.</p> <p>A legal entity as referred to in point (c) of the first subparagraph shall be subject to prudential regulation and ongoing supervision and shall satisfy the following minimum requirements:</p> <p>(a) it shall have the infrastructure necessary to keep in custody financial instruments that can be registered in a financial instruments account opened in the depositary's books;</p> <p>(b) it shall establish</p>	<p>The depositary shall be:</p> <p>(a) a credit institution having its registered office in the Union and authorised in accordance with Directive 2006/48/EC;</p> <p>(b) an investment firm having its registered office in the Union, subject to capital adequacy requirements in accordance with Article 20(1) of Directive 2006/49/EC including capital requirements for operational risks and authorised in accordance with Directive 2004/39/EC and which also provides the ancillary service of safe-keeping and administration of financial instruments for the account of clients in accordance with point (1) of Section B of Annex I to Directive 2004/39/EC; such investment firms shall in any case have own funds not less than the amount of initial capital referred to in Article 9 of Directive 2006/49/EC; or</p> <p>(c) <b>another category of institution that is subject to prudential regulation and ongoing supervision and which, on 21 July 2011, falls within the categories of institution determined by Member States to be eligible to be a depositary under</b></p>

	<p>adequate policies and procedures sufficient to ensure compliance of the entity, including its managers and employees, with its obligations under this Directive;</p> <p>(c) it shall have sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment and effective control and safeguard arrangements for information processing systems;</p> <p>(d) it shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest;</p> <p>(e) it shall arrange for records to be kept of all services, activities and transactions that it undertakes, which shall be sufficient to enable the competent authority to fulfil its supervisory tasks and to perform the enforcement actions provided for in this Directive;</p> <p>(f) it shall take reasonable steps to ensure continuity and regularity in the performance of its depositary functions by employing appropriate and proportionate systems, resources and procedures including to perform its depositary activities;</p> <p>(g) all members of its</p>	<p><b>Article 23(3) of Directive 2009/65/EC,</b></p> <p>For non-EU AIFs only, and without prejudice to point (b) of paragraph 5, the depositary may also be a credit institution or any other entity of the same nature as the entities referred to in points (a) and (b) of the first subparagraph of this paragraph provided that the conditions in point (b) of paragraph 6 are met.</p>
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	<p>management body and senior management, shall, at all times, be of sufficiently good repute, possess sufficient knowledge, skills and experience;</p> <p>(h) its management body shall possess adequate collective knowledge, skills and experience to be able to understand the depositary's activities, including the main risks;</p> <p>(i) each member of its management body and senior management shall act with honesty and integrity,</p> <p>3, Member States shall determine which of the categories of institutions referred to in the first subparagraph of paragraph 2 shall be eligible to be depositaries,</p> <p>4, Investment companies or management companies acting on behalf of the UCITS that they manage, which, before 18 March 2016, appointed as a depositary an institution that does not meet the requirements laid down in paragraph 2, shall appoint a depositary that meets those requirements before 18 March 2018,</p>	
Discharge of responsibility	Article 24	Article 21,13
	<p>1, Member States shall ensure that the depositary is liable to the UCITS and to the unit-holders of the UCITS for the loss by the depositary or a third party to whom the custody of financial instruments held in custody in accordance</p>	<p>The depositary's liability shall not be affected by any delegation referred to in paragraph 11,</p> <p><b>Notwithstanding the first subparagraph of this paragraph, in case of a loss of financial instruments held in</b></p>

	<p>with point (a) of Article 22(5) has been delegated,</p> <p>In the case of a loss of a financial instrument held in custody, Member States shall ensure that the depositary returns a financial instrument of an identical type or the corresponding amount to the UCITS or the management company acting on behalf of the UCITS without undue delay, The depositary shall not be liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary,</p> <p>Member States shall ensure that the depositary is also liable to the UCITS, and to the investors of the UCITS, for all other losses suffered by them as a result of the depositary's negligent or intentional failure to properly fulfil its obligations pursuant to this Directive,</p> <p>2, The liability of the depositary referred to in paragraph 1 shall not be affected by any delegation as referred to in Article 22a,</p> <p>3, The liability of the depositary referred to in paragraph 1 shall not be excluded or limited by agreement,</p> <p>4, Any agreement that contravenes paragraph 3 shall be void,</p> <p>5, Unit-holders in the UCITS may invoke the liability of the depositary directly or indirectly</p>	<p><b>custody by a third party pursuant to paragraph 11, the depositary may discharge itself of liability if it can prove that:</b></p> <p><b>(a)all requirements for the delegation of its custody tasks set out in the second subparagraph of paragraph 11 are met;</b></p> <p><b>(b)a written contract between the depositary and the third party expressly transfers the liability of the depositary to that third party and makes it possible for the AIF or the AIFM acting on behalf of the AIF to make a claim against the third party in respect of the loss of financial instruments or for the depositary to make such a claim on their behalf; and</b></p> <p><b>(c)a written contract between the depositary and the AIF or the AIFM acting on behalf of the AIF, expressly allows a discharge of the depositary's liability and establishes the objective reason to contract such a discharge.</b></p>
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	through the management company or the investment company provided that this does not lead to a duplication of redress or to unequal treatment of the unit-holders.	
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## Annex 10: Comparison of empowerment acts regarding depositaries in the UCITS V and AIFMD

UCITS V empowerment (Article 26b)	AIFMD empowerment (Article 21 (17))
1) the particulars that need to be included in the written contract (with a third party)	1) the particulars that need to be included in the written contract (with a third party)
	<b>2) general criteria for assessing whether the prudential regulation and supervision of third countries [...] have the same effect as Union law and are effectively enforced;</b>
2) the conditions for performing the depositary functions including: -the types of financial instrument to be included in the scope of the custody duties of the depositary	3) the conditions for performing the depositary functions - the type of financial instruments to be included in the scope of the depositary's custody duties
- the conditions subject to which the depositary is able to exercise its custody duties over financial instruments registered with a central depositary;	- the conditions subject to which the depositary is able to exercise its custody duties over financial instruments registered with a central depositary; and
- the conditions subject to which the depositary is to safekeep the financial instruments issued in a nominative form and registered with an issuer or a registrar,	- the conditions subject to which the depositary is to safekeep the financial instruments issued in a nominative form and registered with an issuer or a registrar,
3) the due diligence duties of depositaries	4) the due diligence duties of depositaries
4) the segregation obligation	5) the segregation obligation
<b>5) the steps to be taken by the third party</b>	
6) the conditions subject to which and circumstances in which financial instruments held in custody are to be considered to be lost	6) the conditions subject to which and circumstances in which financial instruments held in custody are to be considered as lost;
7) 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	7) 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
	8) the conditions subject to which and circumstances in which there is an objective reason to contract a discharge
<b>8) the conditions for fulfilling the independence requirement</b>	

**Annex 11: Comments and Discrepancies between the provision, the AIFMD and the ESMA advice,**

<b><u>Empowerments which are both in AIFMD and UCITS Directive</u></b>		
<b>Article in the UCITS Directive</b>	<b>Description</b>	<b>Comments on substantive discrepancies between the provision and the AIFMD level 2</b>
Article 22(2)	The particulars that need to be included in the written contract	Changes, in comparison to the AIFMD have been introduced to ensure consistency between the UCITS level 1 and the level 2. For example, the reference of the discharge of liability has been deleted in this Article, as under UCITS V depositary is not allowed to discharge its liability by means of a contractual arrangement with a third party, by the same token, the reuse of assets by the sub-custodian is prohibited by level 1.
Article 22(3)	Oversight duties - general requirements	No changes
Article 22(3)(a)	Duties regarding subscription and redemptions	No changes
Article 22(3)(b)	Duties regarding the valuation of units	Changes, in comparison to the AIFMD level 2 have been introduced to ensure consistency between the UCITS level 1 and the level 2. For example, the reference of the valuator has been deleted in this Article as the rules regarding valuation of assets and calculation of units' price of UCITS are regulated at the national level.
Article 22(3)(c)	Duties regarding the carrying out of the UCITS's instructions	No changes
Article 22(3)(d)	Duties regarding the timely settlement of transactions	No changes
Article 22(3)(e)	Duties related to the UCITS's income distribution	Alignment with UCITS level 1 with respect to the specific elements of remuneration

Article 22(4)	Cash monitoring	Minor legal redrafting to align with UCITS level 1.
Article 22(5)	<p>The conditions for performing the depositary functions</p> <ul style="list-style-type: none"> <li>- financial instruments to be held in custody</li> <li>- safekeeping duties with regard to assets held in custody</li> <li>- safekeeping duties regarding ownership verification and record keeping</li> </ul>	Minor legal redrafting to improve the clarity of the text and alignment with UCITS level 1.
Article 22a(2)(c)	The due diligence duties of depositaries	<p>No substantive changes in comparison to AIFMD, however following ESMA advice insolvency protection of assets will be reinforced by the requirement to seek an independent legal advice on the enforceability of the contract and notification obligations of the depositary and management/investment company.</p> <p>Minor legal redrafting to improve the clarity of the text and alignment with UCITS level 1.</p>
Article 22a(3)(c)	The segregation obligation	Minor legal redrafting to improve the clarity of the text and alignment with UCITS level 1.

Article 24	The conditions subject to which and circumstances in which financial instruments held in custody are to be considered to be lost	No changes
Article 24(1)	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	No changes

<b><u>Empowerments which are not included in AIFMD</u></b>		
<b>Article in the UCITS Directive</b>	<b>Description</b>	<b>Comments and discrepancies between the provision and ESMA advice</b>
Article 22a(3)(d)	The steps to be taken by the third party in the event of an insolvency	<p>Some legal drafting changes to align the legal text with UCITS level 1. For example, the obligation to receive <i>ex ante</i> legal advice on the insolvency law and the legal and custodian risk in case of the insolvency of a third party is placed on the depositary who, in turn, will have to require it from a third party prior to entry into contractual relation. The reformulation of the ESMA advice was necessary to the extent the obligations imposed by the EU law can only be imposed directly on the entities located in the EU.</p> <p>Parts of the advice which were going beyond the empowerment for Article 22a(3) (d), in particular referring to the depositary's tasks or issues not related to the insolvency protection of assets, were not taken on board for this provision. Most of them are already included in the provision on due diligence obligations</p>
Article 25(2)	Conditions for fulfilling the independence requirement	No discrepancy between the provision and ESMA advice, This point is impact-assess in this impact assessment.

## **Annex 12: Summary of ESMA public consultation on UCITS advice**

This Annex presents relevant excerpts from a longer summary that had been prepared by ESMA staff.

ESMA received 60 responses to the consultation by the deadline.

- Insolvency protection of UCITS assets when delegating safekeeping:

The most prominent concern relates to the task of the third party set out in paragraph 1(a)(i) of the draft final advice to make all reasonable efforts, including the receipt of legal advice from a natural or legal person non-affiliated to the third party, to verify the applicable insolvency laws and jurisprudence. However, a number of stakeholders objected to the requirement for independent legal advice, arguing that it would generate additional costs and noting the difficulties involved in assessing the applicable regimes in third countries. These stakeholders suggested that it should be possible to rely on internal advice from within the group, or to leverage on advice that might be available from other sources (e.g. industry associations).

- Requirement that the management company and depositary would ‘act independently’

### ***a) Common management / supervision***

Most respondents to the consultation agreed with the prohibition on common membership of the management bodies of the management company /investment company and depositary and with a tailored approach foreseen for situations in which the management body of the management company/investment company and depositary is not in charge of the supervisory functions.

### ***b) cross-shareholding / group inclusion***

A large majority of respondents agreed that common management/supervision may jeopardise the independence of the two entities, a number of them objected to the idea that cross-shareholdings may as such trigger the same consequence. In contrast, several respondents (including consumer representatives) were of the view that any of the links (common management/ supervision or cross-shareholdings) may affect the independence.

The majority of respondents objected to the proposed prohibition on cross-shareholdings for a number of reason including (i) that it would be disproportionate, (ii) that it went beyond the Level 1 provisions which refer to the obligation to ‘act independently’ thus implying functional, not structural independence, (iii) it was likely to increase systemic risk as it would lead to a concentration of depositary activities and (iv) that it would lead to substantial costs.

On other hand, a number of respondents (including consumer representatives) favoured this option on the basis that it would ensure the highest standard of investor protection and is the most straightforward way to address the issue of conflicts of interest.

**Annex 13: Summary of the US rules that would apply if asset managers and custodians belong to a corporate group or have cross-shareholdings between each other.**

**The related person rule**

The applicable rule is Rule 206(4)-2 of the 1940 Investment Advisers Act. Rule 206(4)-2 does not require use of independent custodians. Rather, the rule imposes additional requirements when client assets are maintained by the adviser itself or by a “related person” instead of an independent qualified custodian. A “related person” is defined in rule 206(4)-2 as any person, directly or indirectly controlling the adviser, controlled by the adviser or under common control with the adviser (group scenario).

The related person must be a “qualified custodian.” This would resemble the EU approach whereby the depositary (who also provides the custody function) has to be a credit institution authorised in accordance with Directive 2013/36/EU or a another legal entity, authorised by the competent authority under the law of the Member State to carry out depositary activities under the UCITS Directive.

Rule 206(4)-2 considers an investment adviser that is also registered as a broker-dealer whose clients maintain assets in brokerage accounts as a qualified custodian. The rule also applies when client assets are maintained with a related person that is a broker-dealer, bank, or futures commission merchant. The list of eligible custodians is therefore roughly comparable with the UCITS rules.

Rule 206(4)-2 differentiated between related persons that are "operationally independent" and those that are not. Firms under common ownership can be operationally independent of each other. According to the SEC, operational independence presents substantially lower client custodial risk because misuse of client assets would tend to require collusion among employees. Employee collusion is less likely when both units do not have common employees or joint management. According to rule 206(4)-2 an adviser and a related person are presumed not to be operationally independent unless each of the following conditions is met:

- a. Client assets in the custody of the related person are not subject to claims of the adviser’s creditors;
- b. Advisory personnel do not have any access to or possession of client assets, or power to control dispositions of client assets for the benefit of the adviser or its related person, or otherwise have the opportunity to misappropriate such client assets;
- c. Advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and
- d. Advisory personnel do not hold any position with the related person or share premises with the related person.

Most relevant for our case: The SEC has stated that it would not consider a related person operationally independent of the adviser if that person shares any managers with the adviser, or if the related person has an owner that is actively engaged in the management of the two firms (2009 Adopting Release at n. 111). The SEC also verifies whether no other circumstances exist that can reasonably be expected to compromise the operational independence of the related person, such as whether the management of the adviser and the



related person could be controlled by persons with close familial relationships such as spouses, siblings, or parents and adult children (2009 Adopting Release at n.112).

### **Safeguards on how to deal with related persons that are not operationally independent**

If the related person acting as qualified custodian is not “operationally independent” of the adviser, Rule 206(4)-2 requires that an adviser whose client assets are maintained with a related person be subject to (1) a surprise examination and (2) obtain an internal control report from the independent public accountant. The surprise examination must be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.

The adviser must obtain or receive, from the related person acting as the qualified custodian, an annual report of the internal controls relating to the custody of client assets prepared by an independent public accountant registered with, and subject to regular inspection by, the PCAOB. The report must contain an opinion of the accountant as to whether controls that meet the control objectives relating to custodial services, including the safeguarding of funds and securities held by either the adviser or the related person, are suitably designed, placed in operation, and are operating effectively. The accountant must also verify that the funds and securities are reconciled to a custodian other than the adviser or the related person (such as the Depository Trust Corporation).

If a related person acts as custodian, additional reporting obligations under Form ADV – to be filled in by financial advisers - apply. When the adviser acts as, or has a related person act as, the qualified custodian, Form ADV requires the adviser to report its approach in complying with the custody rule, as well as to identify any custodian that is a related person (Form ADV Item 9(C) and (D)).

Form ADV also requires advisers that were subject to the surprise examination requirement during the previous fiscal year or had a pooled investment audited for the previous fiscal year to identify the independent public accountant that performed the surprise examination or audited the pool.

In addition, the SEC has defined the notion of " operationally independent" in their SEC Adopting Release at No 111: Amended rule 206(4)-2(d)(5) (defining “operationally independent”). The conditions set out in the rule are: (i) client assets in the custody of the related person are not subject to claims of the adviser’s creditors; (ii) advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person.

## Annex 14 – Examples of supervision and sanctions powers of national competent authorities

### United Kingdom

#### Financial Services and Markets Act 2000 (FSMA 2000) and FCA Handbook

FSMA 2000 requires individuals performing controlled functions for a regulated firm to be approved by the FCA (or, depending on the type of firm, the PRA).

The members of the Board of a regulated firm will have to be approved to carry out controlled functions and will be subject to the FCA's Statements of Principle and Code of Practice for Approved Persons (APER). APER sets out the fundamental obligations of approved persons and outlines a number of principles applicable to approved persons. The most relevant appear to be:

##### Statement of Principle 1

*An approved person must act with integrity in carrying out his accountable functions.*

##### Statement of Principle 4

*An approved person must deal with the FCA, the PRA and other regulators in an open and cooperative way and must disclose appropriately any information of which the FCA or the PRA would reasonably expect notice.*

FSMA 2000 attributes powers to the FCA to take Enforcement action against individuals performing controlled functions and firms: these are outlined, where relevant, in the responses to the questions below.

#### What happens if the views of an independent board member are ignored?

When the views of an independent board member are ignored these should be recorded in the minutes of the board meeting. The dissenting board member would generally require that his/her dissenting views are documented. Depending on the gravity of the situation, the FCA would expect the member of the Board whose views are being ignored to consider informing the FCA of any concerns in compliance with the APER Statement of Principle 4 which requires approved persons to “*disclose appropriately any information of which the FCA or the PRA would reasonably expect notice*”.

#### Are these views documented?

Yes these views should be documented and the records should be kept by the firm in accordance with the FCA's general record-keeping requirements (SYSC 9).

#### If so, can the FCA demand the board to produce these dissenting opinions issued by independent members?

The FCA has general information gathering and investigation powers under Part XI of FSMA 2000. This includes the power to require the provision of information (s.165) or to require reports from skilled persons (s.166). Under the FCA Principles for Businesses (PRIN) a firm is required to “*deal with its regulators in an open and cooperative way, and to disclose to the appropriate regulator (i.e., the FCA) appropriately anything relating to the firm of which that regulator would reasonably expect notice*” (Principle 11). To comply with this Principle, firms are expected to: give representatives or appointees of the appropriate regulator reasonable access to any records, files, tapes or computer systems, which are within the firm's possession or control, and provide any facilities which the representatives or appointees may reasonably request; and produce to representatives or appointees of the appropriate regulator specified documents, files, tapes,

computer data or other material in the firm's possession or control as reasonably requested (see SUP 2.3.3G (2) and (3)).

**If so, under what circumstances can the FCA request such documents?**

The FCA has the power to request such information and documents as long as they are required in connection with the performance of its ordinary supervisory function (see s.165 of FSMA 2000).

**What regulatory action can the FCA take once it discovers that the views of an independent board member, e.g., a member of the depositary's/custodian's board on the inaccurate valuation of funds by the manager, are ignored?**

This will depend on the specific circumstances and gravity of the situation. Firms must comply at all times with the FCA threshold conditions which are minimum standards that firms need to satisfy to retain their regulatory permissions (COND).

Under the 'Suitability' condition the firm's business must be managed in such a way as to ensure that its affairs are conducted in a sound and prudent manner and that those managing the firm's business act with probity. If in the specific circumstances the firm, in the FCA's view, no longer meets these conditions then action could be taken under s.55J and s.55L FSMA 2000 to vary or cancel the firm's permissions (in the most serious cases) or to impose a requirement on the firm to take, or refrain from taking, a specified action. If appropriate, the requirement could also be published on the FCA's register.

**What consequence would it have for the entity involved if the FCA discovers that persistent objections, which prima facie appeared legitimate, were brushed off by the majority of the board?**

1. This will also depend on the gravity of the specific circumstances. If the fact is considered to be a contravention of a relevant FCA requirement (e.g. one of the FCA's Principles for Businesses) the FCA can exercise one or more of the following powers against the firm:
2. Public censure (publication of a statement to inform the public of such contravention) (s.205 FSMA 2000)
3. Financial penalties (s.206 FSMA 2000)
4. Suspension or limitations of the permissions to carry out regulated activities (s.206A FSMA 2000)

**Action could also be taken against the directors concerned and in particular:**

1. The FCA can withdraw its approval in relation to the performance by the individual of a controlled function if the individual is no longer considered to be fit and proper (s.63 FSMA 2000)
2. The FCA can exercise disciplinary powers under the individual if (s.66 FSMA 2000):
  - The individual has failed to comply with one of the FCA's Statements of Principle in APER
  - The individual was 'knowingly concerned' in the firm's contravention of an FCA requirement
3. In the cases above the FCA can take the following actions:
  - Impose a financial penalty on the individual
  - Suspend the individual from the performance of a controlled function
  - Impose a limitation on the functions that the individual can perform
  - Publish a statement of misconduct

## France

AMF can obtain information from the detailed mission statement ("cahiers des charges") which the depositary needs to submit upon request. This statement includes information on the control of the activities and resources that the entity has to put into place. AMF can request further documents and insights, e.g. in the framework on on-site inspections.

AMF has also the power to control the relevant entity on its own initiative. AMF continuously monitors the orderly functioning of the companies concerned and controls and sanctions should this not be the case.

The information received by the AMF can originate from different channels, including board members availing themselves of the whistleblowing procedure that will be introduced in the French *code monétaire et financier* or/and the General Regulation with the transposition of UCITS V. As a reaction to this information, the AMF can launch a strengthened monitoring process and, if there is any risk posed for investors organise on-site inspections on an emergency basis and pronounce sanctions.

The Enforcement Committee may issue sanctions against:

- professionals under AMF supervision if they breach their professional obligations under the law, regulations and professional rules approved by the AMF
- individuals acting under the authority or on behalf of these professionals
- any person that commits market abuse, including insider dealing, price manipulation or dissemination of false information, or any other breach that could impair investor protection or interfere with orderly markets.

The applicable sanctions vary depending on the type of respondent and offence:

Person sanctioned	Type of breach	Disciplinary sanction	Fine (*)
Professional under AMF supervision, such as an investment services provider or management company	Individual acting under the authority or on behalf of a professional	Warning, reprimand, temporary or permanent ban on providing some or all services	Up to €100 million or ten times any profit earned
Individual acting under the authority or on behalf of a professional	Failure to meet professional obligations	Warning, reprimand, temporary, suspension or withdrawal of professional licence, temporary or permanent ban on conducting some or all businesses.	Up to €300,000 or five times any profit earned
Individual acting under the authority or on behalf of a professional	Market abuse	Warning, reprimand, temporary, suspension or withdrawal of professional licence, temporary or permanent ban on conducting some or all businesses.	Up to €15 million or ten times any profit earned
Other persons (issuers and their executives, auditors, others)	Market abuse	N/A	Up to €100 million or ten times any profit earned

(\*) For breaches committed on or after 24/10/2010 (cf. Act 2010-1249 of 22 October 2011)

## *Luxembourg*

Article 147 of the law of 17 December 2010 on undertakings for collective investment, provides for the following:

"(1) For the purposes of application of this Law, the CSSF is granted all supervisory and investigative powers that are necessary for the exercise of their functions.

(2) The powers of the CSSF shall include the right to:

- a) access any document in any form and receive a copy thereof;
- b) require any person to provide information and, if necessary, to summon and question any person with a view to obtaining information;
- c) carry out on-site inspections or investigations, by itself or by its delegates, of persons subject to its supervision under this Law;
- d) require communication of the telephone exchanges and existing data;
- e) require the cessation of any practice that is contrary to the provisions adopted in implementation of this Law;
- f) request the freezing or the sequestration of assets by the president of the District Court of and in Luxembourg acting on request;
- g) pronounce the temporary prohibition of exercising professional activities against the persons subject to its prudential supervision, as well as the members of administrative, governing and management bodies, employees and agents linked to these persons;
- h) require authorised investment companies, management companies or depositaries to provide information;
- i) adopt any type of measure to ensure that investment companies, management companies or depositaries continue to comply with the requirements of this Law;
- j) require the suspension of the issue, repurchase or redemption of units in the interest of the unitholders or of the public;
- k) withdraw the authorisation granted to an undertaking for collective investment ("UCI"), a management company or a depositary;
- l) transmit information to the Public Prosecutor for criminal proceedings; and
- m) instruct *réviseur d'entreprises agréé* (*approved statutory auditor*)s or experts to carry out verifications or investigations."

## *Germany*

According to § 5 par. 6 of the German Capital Investment Act (Kapitalanlagegesetzbuch - KAGB), the supervisory authority (BaFin) has comprehensive investigation and intervention powers:

"The Bundesanstalt shall carry out the supervision of compliance with the prohibitions and requirements stipulated by this Act and by regulation based on this Act and is empowered to issue all orders which are necessary and appropriate to enforce them. Furthermore, the Bundesanstalt shall have the power to issue all orders in the course of supervision which are necessary and appropriate to ensure compliance with the fund rules or the funds' articles of

association. To the extent that evidence exists that this is necessary for the supervision of a prohibition or requirement pursuant to this Act, the BaFin may in particular:

1. obtain information and request the submission of documents and the surrender of copies from any person, summon and question any person and
2. request existing telephone and data traffic records..."

Based on this empowerment, BaFin may request the minutes of meetings of the supervisory board from a fund management company or a fund depository if there is any hint of a breach of law or non-compliance with the fund rules. If a member of the supervisory board expresses concerns in this regard, BaFin will have to further investigate whether these concerns are based on facts. If it comes to the conclusion that there is any breach of law or non-compliance with the fund rules, it will issue the orders necessary to remove the breach and avoid further breaches.

In this context, please also note § 18 par. 4 KAGB which stipulates that "The personality and expertise of the members of the supervisory board or of an advisory board shall be such as to guarantee the protection of the investors' interests.

If BaFin discovers that a majority of board members constantly ignore legitimate concerns of one or two members, it may take the view that all or some of the majority members of the board are no longer suitable for their position, and an order their dismissal. If repeatedly ignored concerns are based on facts that are also known to the company's executive board or some of its employees, BaFin may consider the company's risk control system to be inefficient, and issue orders to improve it.

### *Italy*

The CONSOB and the Banca d'Italia, pursuant to the powers attributed to them, whenever deem it necessary for carrying out the investigations, require the transmission of documents, such as the bylaws on how the board operates and board minutes.

Then, CONSOB and Banca d'Italia can activate further powers (among other: sanctions, convening the governing body, members, directors and auditors for interviews and enquiries). The intervention powers depend on the seriousness of the potential infringement or irregularity.

Article 13 of Legislative Decree no. 58 of 24 February 1998

#### **Experience, integrity and independence requirements for corporate officers<sup>138</sup>**

1. Persons performing administrative, management and supervisory functions in Italian investment companies, asset management companies or SICAVs and SICAFs shall fulfil the experience, integrity and independence requirements established by the Minister of the Economy and Finance in a regulation adopted after consulting the Bank of Italy and Consob<sup>139</sup>.
2. Failure to fulfil the requirements shall result in disqualification from office. The disqualification shall be declared by the board of directors, the supervisory board or the management board within thirty days of the appointment or of it becoming aware of the failure.
3. In the event of inaction by the board of directors the disqualification shall be declared by the Bank of Italy or Consob.

3bis. In the event of failure to fulfil the independence requirements established by the Civil Code or the Articles of Association, subsections 2 and 3 shall apply.<sup>141</sup>

4. The regulation referred to in subsection 1 shall establish the grounds for temporary suspension from office and its duration. The suspension shall be declared in the manner established in subsections 2 and 3.

### *Ireland*

The Central Bank operates an intrusive and directive risk-based supervisory regime (called PRISM) which focusses resources on regulated entities based on their 'impact' which is a concept calibrated to the damage firms can do when they fail. For the Market Supervision Directorate, depositories constitute the population of firms with the highest impact ratings.

Under PRISM, there are predetermined engagement cycles where firms with certain impact ratings (medium-low, medium-high and high) are subject to full risk assessments on a periodic basis where the frequency is based on their impact.

Governance is a risk area which the Central Bank has focussed a lot of attention. Under PRISM, the Central Bank has instructed fund service providers to have independent directors. This is done by issuing Risk Mitigations Plans to depositories that do not have independent directors on their board.

Also, as part of our Governance assessments, board minutes are requested as part of full risk assessments and reviewed to ensure that there is a sufficient level of challenge demonstrated. These changes have taken place without the need for our UCITS regime to require that at least one-third of a board or two members be independent. That said, there is, in fact, an industry corporate governance code covering both depositories and UCITS management companies which requires that they have one independent board member.

As a matter of course independent board members will bring matters of concern to the Central Bank's attention. Directors require approval from the Central Bank before being appointed on a new board and independent directors are very aware of the importance of protecting their professional reputation.

It is also worth noting that our key concern and focus when assessing depositories and their related management companies is the reporting lines which are in place for both entities and these must be sufficiently robust to ensure independence. And we have issued Risk Mitigation Plans in some instances where we consider that independence between the two firms could be compromised.

## Annex 15 – Other impacts of Options 2.2 and 2.3

### Others impacts (competition, market structure, financial stability)

#### Impact on international competitiveness

**Option 2.3** is in line with IOSCO principles on the custody of collective investment schemes. Principle 4 of IOSCO principles requires that “the custodian should be functionally independent from the responsible entity”. IOSCO does not require the absence of cross-shareholdings or excluding membership of a single group. Therefore, **Option 2.3** is aligned to prevailing international standards; a fact which avoids making the EU asset management or depositary sectors less competitive on an international plane.

Europe's main competitor in the area of asset management, the United States, also does not require structural separation between an asset management company and a depositary. The US notion of a "related person" that is not operationally independent of the adviser in the US rules mirrors **Option 2.3** approach considering that the decisive criteria that puts into doubt independent behaviour is not "common ownership" but "operational independence". This independence is lost once the advisor and the custodian have the above links and, in particular, share common management.

In addition, once a "related person" is not operationally independent, a series of safeguards and independent verifications have to be put in place. It is difficult to assess whether being subject to surprise visits and internal control reports is more or less onerous than the proposed approach in **Option 2.3** to institute a quorum of independent board members. The additional controls required by Rule 206(4)-2 do seem rather strict, so a case could be made that **Option 2.3** approach might prove less onerous and/or costly.

On the contrary, **Option 2.2** will diminish the competitiveness of the European Union compare to the United States, as the United States does not have such strict rule on the structural separation.

#### Impact on competition and market structure

**Option 2.2** will entail a large scale restructuring of custodial assets in most Members States (at least € 2.5 trillion or 32% of EU domiciled UCITS assets may be affected<sup>98</sup>) without, however, entailing an immediate improvement of competition in the European depositary markets and without ensuring sufficient proportionality. This is because a reshuffling of assets, due to the above mentioned economies of scale and scope required in operating custody networks, would most likely involve existing suppliers; it is unlikely that the reshuffling will lead to significant new entry.

More widely, this option will entail a large scale restructuring of depositary business as in average 56% of EU based asset managers use “group” depositary. This percentage is close to 100% for small asset managers that have a banking company as an affiliate company or part of the group.

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<sup>98</sup> See Table 6 in Annex 5.



This conclusion is borne out by the fact that asset managers that do not belong to a banking group tend to place their assets in custody with the biggest providers, such as JP Morgan, Bank of New York Mellon, State Street, CACEIS or BNP Paribas Securities Services. As mentioned in section 1.4, BlackRock manages approximately € 220 bn of UCITS assets in Europe and custody is spread across three of the major providers: JP Morgan (€62 bn), Bank of New-York Mellon (€ 146 bn) and State Street (€ 12 bn). Aberdeen entrusts custody to either BNP Paribas or State Street.

As evidenced by the sheer size of the big five depositaries, it is reasonable to expect that most of the custody flows would be directed to the larger suppliers in this market which can offer attractive price and a global network. This movement already triggered 10 years ago.

In addition, as mentioned above, economies of scale are a hallmark of the modern (mostly electronic) depositary business. Indeed, most management/investment company have, already in the past, favored the biggest depositary service providers, essentially because they offer economies of scale and a global network of custodians. For example, it is significant to note that only the "top nine" depositaries listed in Annex 5 have a territorial coverage ranging from 3 to 9 Member States all other operators are confined to the territory of one, at maximum, two Member States. It can thus be anticipated with a reasonable level of confidence that the restructuring of custodial assets that will be required under **Option 2.2** will result in net inflows toward the biggest custodians with the widest geographic coverage. This analysis mirrors the conclusions in the ECB's Occasional Paper No 68 which states:

"Single-market custodians (custodians that are only active in a single jurisdiction) share the specific challenge of competing with multi-direct custodians on both service and cost, but with significantly less economies of scale or scope. Banking mergers may help some single-market custodians acquire scale."<sup>99</sup>

In addition, on account of the economies of scale that result from their larger scale of operations and global network, bigger suppliers are in a position to offer more attractive custody rates. It is therefore not unreasonable to expect that smaller depositaries, that currently generate economies of scale by means of a high percentage of in-group assets, would lose some or all of these economies of scale and would be unable to represent a viable alternative to the bigger custody providers.

While it might be conceivable that smaller players (with currently large percentages of in-house assets) would set up independent entities to provide depositary services, however, these new entities are expected to have a slim chance of staying on the market because it could be difficult for them to respect high strict quality standard<sup>100</sup> of the service and facing in the same time to the price pressure initiate by the big players.

In addition, the current tendency of large depositaries to delegate custody (in other group) among themselves is expected to change because of the stricter rules on delegation and on reuse of assets imposed by UCITS V.

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<sup>99</sup> ECB Occasional Paper No 68, p. 38.

<sup>100</sup> See Annex 9

Table 6 in Annex 5 demonstrates that only some depositaries with assets from the “group” management/investment company could reasonably expect to maintain economies of scale subsequent to the reallocation of assets required under **Option 2.2** as their in-house business is in average less than 32% of their overall custody.

This demonstrates that, without the possibility of using synergies from an in-group business model the smaller depositaries might not be able to have a chance to face the competition in the UCITS’ depositary business<sup>101</sup> and could be forced to shut down. For these reasons a reshuffling of assets is likely to foster the above stated concentration of assets among the existing “top five” depositaries (State Street, JP Morgan, Bank of New-York Mellon, CACEIS and BNP Paribas Securities Services) thus increasing the level of concentration in the depositary markets and leading to further concentration.

**Option 2.3** poses less risk of an increased asset flow to the big providers. On the contrary, the fact that at least 32%<sup>102</sup> of UCITS assets could remain in custody within a single group appears as a safeguard that also smaller in-house custodians will remain in the custody business even if that is predominantly safekeeping assets on behalf of their group companies.

**Option 2.3** has less cost consequences on the market structure while it still ensures the robustness of the independence requirement established in the UCITS Directive by providing a set of behavioural criteria to ensure that a depositary and the management/investment company preserve the interest of UCITS and investors of the UCITS and acting independently while carrying out their respective functions is only one of those criteria.

**Option 2.3** will not entail the need for a large-scale reallocation of assets or significant costs for asset managers or depositaries. Costs associated with this option are essentially linked to annual cost of salaries that have to be paid to the required quorum of independent board members.

In addition, members of the management body may be faced to a situation of conflict of interests without having a cross shareholding link or be part of the same group. This situation may arise when the members of the management body have a contractual or affiliate link. **Option 2.3** has the merit to cover also these situations by providing a set of behavioral criteria but also by requiring independent members that have no material or personal affiliation with the other entity; this will ensure the robustness of the independence.

### Systemic impacts

Another relevant consideration is the avoidance of exposure to a single financial counterparty. **Option 2.2** would indeed offer one potential way to limit the exposure to a financial counterparty because the custody operations would be “ring-fenced” and therefore separated from the asset management operations.

On the other hand, diversification of services can also contribute to a financial counterparty's stability and liquidity. It might be safer for investors to have exposure to a larger and

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<sup>101</sup> However as there is no empowerment in AIFMD requiring the AIF depositary to act independently, small players could not lose entirely their depositary business and keep this business for AIFs.

<sup>102</sup> See table 6 in Annex 5.

diversified financial counterparty than to a specialist operation that only provides custody. In addition, the overall tendency is that specialist custodians need increasing scale to operate profitably.

However, the operational failure or bankruptcy of a large depositary/custodian could negatively impact the functioning of financial markets as a whole, especially if the failing entity impedes the ability of other institutions to meet their obligations.

Systemic impacts may arise when one institution's inability to meet its obligation makes other institutions unable to meet their obligations, resulting in significant liquidity and credit bottlenecks that are prone to undermine confidence in the markets. Such scenarios, usually referred to as contagion, knock-on or domino effect, could arise if a custodian that exceeds a certain size were to fail.

The risks that could result from the failure for a systemically relevant custodian fall into three general categories: operational, financial and legal.

For example, the operational failure of a large custodian could lead to failures in data processing and could stop a depositary from processing a UCITS' instructions to, say, make cash payments and receive or deliver investment securities. Should a depositary be unable to pay cash due to operational problems, UCITS could experience liquidity bottlenecks. The inability of a UCITS custodian to execute deliveries and receipts of securities could likewise impact the liquidity of a UCITS fund.

Likewise, an inability to make payments for securities transactions due to a depositary's financial failure or instability could, like operational problems that prevent the processing of payments, cause liquidity bottlenecks for a UCITS fund. The systemic impact of the financial failure of a depositary or custodian depends on its size and the overall value of its payment obligations.

In light of the above, a further consolidation of the depositary and, in particular, custody markets that might result from **Option 2.2** is prone to increase risks to financial market stability, in particular systemic risk linked to a potential operational or financial failure of one of the emerging top 5 custodians.

The more heterogeneous and diversified depositary market that might result from **Option 2.3** would contribute to the avoidance of some of the above described negative repercussions associated with the failure of a systemically relevant custodian.