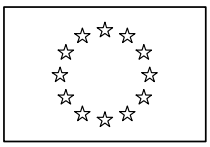

COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND TO THE EUROPEAN PARLIAMENT

Regulation of UCITS depositaries in the Member States: review and possible developments

1. The UCITS depositary plays a specific role in protecting investors:

With around 3,500 billion euros of assets under management, UCITS (Undertakings for Collective Investment in Transferable Securities) – harmonised investment funds – are the predominant investment vehicle for the average European household. They provide retail investors with the benefits of financial market risk diversification and expertise in investment management, at reasonable cost, by pooling investors' savings.

The UCITS depositary is entrusted with safekeeping the assets of UCITS funds and performing a series of controls for the sake of investors. Without the depositary, it could be far easier for devious fund managers to cheat investors on the transactions made or even run away with the securities and liquidities owned by the fund, as has happened in some major scandals. Recent investigations in the US have uncovered some worrying malpractice (e.g. allegations of hedge funds making illegal transactions in investment funds at the expense of retail investors), which a sound depositary system should contribute to prevent (US laws do not make it compulsory for US fund managers to have such a depositary, contrary to the EU). So the depositary is a crucial prudential safeguard for UCITS investors.

2. The current regulation of UCITS depositaries at EU level:

Since the creation of the EU legal framework with Directive 85/611/EEC[1], the depositary has been one of the three fundamental pillars of that framework, alongside the fund (UCITS) and its manager. But it is subject to a very limited number of principles and duties at EU level.

2.1 UCITS depositaries are being defined by default and have no European passport

The depositary is defined in Article 1a of amended Directive 85/611/EEC as "*any institution entrusted with the duties mentioned in Articles 7 and 14* [prudential missions] *and subject to the other provisions laid down in Sections III a and IV a*" of the Directive: this reference covers the rather general missions and obligations, which the depositary of a unit trust/common fund –respectively, of an investment company– has to fulfill. It is important to note that the depositary's legal nature is thus left to Member States' discretion. Moreover, a UCITS may be authorised only if the competent authorities approve the choice of the depositary, whose directors must be of sufficiently good repute and sufficiently experienced "*also in relation to the type of UCITS to be managed*" (precision introduced by Directive 2001/107/EC).

In terms of resources and supervision, the Directive only requires the depositary to "*furnish sufficient financial and professional guarantees to be able effectively to pursue its business as a depositary and meet the commitments inherent in that function*". No precision is included regarding the specific organisation and internal controls of the depositary function. Although the depositary is "*an institution subject to public control*", it need not necessarily be subject to genuine prudential supervision: in particular, no reporting obligation to the competent authorities is required.

The Directive also specifies that the depositary must have its registered office, either in the same Member State as the authorised fund manager (management company or investment company), i.e. the Member State where the UCITS is authorised, or in another Member State,

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

provided it has a branch in the UCITS' Member State – it is then subject to the local UCITS competent authorities' approval and "public control". This is restrictive in the modern Internal Market.

2.2 Depositaries have certain prudential duties, but with vague legal content

The segregation of assets outside the fund management company, which was inspired by the lessons of the late-60's IOS scandal, was reflected in the 1985 Directive by the depositary's identification as the entity responsible for safe keeping UCITS assets. Similarly, by including a list of key prudential controls (see Annex II), the Directive aimed implicitly to curb other risks of conflict of interests on the fund manager's side.

But the scope of the depositary's liability is not fully specified. The Directive clarifies that it is not affected by the fact that depositary has "*entrusted to a third party all or some of the assets in its safe-keeping*". However, this does not clarify the exact contents of the "safe-keeping" concept (see below). More generally, the Directive does not specify whether the performance of any control duty is subject to an obligation of result, or rather to a (lesser) obligation of means. The text of the Directive would seem to support the first interpretation, but this point has never been formally confirmed.

2.3 There are few precise safeguards against conflicts of interest in depositaries

The Directive incorporates the principle of separation and ethical independence between the fund manager and the depositary: both functions cannot be exercised by the same company and both depositary and management company must act "*independently and solely in the interest of the unit-holders*". But the technical safeguards are very limited. The 1985 Directive only included two precise provisions: neither a fund manager nor a depositary acting on behalf of a unit trust could borrow or carry out uncovered sales of transferable securities.

The prerequisites for the outsourcing of functions by delegation are another general issue. During the negotiations, a general ban on the delegation of functions by the management company to the depositary was eventually restricted to the "*core function of investment management*". Nonetheless, the Directive does specify that the delegation of functions "*must not prevent the management company from acting, or the UCITS from being managed, in the best interests of its investors*", and does not affect in any way the management company's or the depositary's liability and responsibilities towards investors and the competent authorities. Regarding the depositary, the Directive does not contain rules on the possible delegation of its tasks or functions (except for custody of asset).

3. A fresh policy approach is required at EU level:

3.1 The Council has mandated a thorough review of the situation

In transposing the UCITS Directives, Member States have often included in their own regulations a broader list of tasks and organisational rules for depositaries, resulting in differing requirements across the EU. Therefore, when adopting, on 5 June 2001, its joint Common Positions regarding future Directives 2001/107/EC[2] and 2001/108/EC[3], the Council

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[2] Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Directive 85/611/EEC [...] with a view to regulating management companies and simplified prospectuses, OJ L 41, 13.02.2002, p.20.

[3] Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Directive 85/611/EEC [...] with regard to investments of UCITS, OJ L 41, 13.02.2002, p.35.

also requested the Commission, in a Declaration accompanying agreement on these Directives, to submit a report "*on the regulation of depositaries according to Directive 85/611/EEC and the need for amending the regulation, accompanied, where appropriate, by a proposal for a revision.*" In the negotiations on Directive 2001/107/EC, the Council Working Party envisaged the inclusion of provisions specifying the depositary's specific functions[4]. However, at the end this was ruled out, pending prior evaluation of the need to further enhance Community harmonisation in this field.

3.2 Preparing a medium-term policy position

Article 2(1) of Directive 2001/108/EC requests the Commission to "*forward to the European Parliament and the Council a report on the application of Directive 85/611/EEC as amended and proposals for amendments, where appropriate*", by mid-February 2005. It is expressly foreseen that the report should *"...evaluate the organisation of funds, including the delegation rules and practices and the relationship between fund manager and depositary"*.

This Communication, which draws on the outcome of a public consultation launched in the autumn 2002[5], concentrates on fulfilling the Council's request on depositaries:

- it reviews the regulations in force in the Member States;
- it identifies the prudential issues that the current situation raises for the consolidation of the Internal Market;
- it proposes a way forward to remedy the problems.

In the medium term, some of these issues will require further in-depth examination, in the light of the concrete implementation of Directive 2001/107/EC regulating UCITS management companies, before considering whether any corrective legislative measures might be appropriate. The outcome of the work to be launched following the present report will therefore be fed into the 2005 overall UCITS report.

4. Key policy issues[6]:

4.1 Depositaries have no full right of establishment

Opportunities of cross-border branching do not benefit from a "European passport" based on a single authorisation in the depositary's Member State of registration: they are subject to case-by-case approval and control in the UCITS Home Member State.

4.1.1 The market for depositary services is highly fragmented across the EU:

Based on data collected by the Commission services (see Annex III- point 4.3), there are two major characteristics of the European UCITS depositary market:

– National markets, and in particular the larger ones, appear closed to foreign competition. Cross-border branching cases are very limited: some 30 cases were reported, against

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4 Regarding terminology issues on the name "depositary": see Annex I. Regarding the provisions examined in 2000 by the Council Working Party: see Annex II.

5 Almost 100 contributors, with various professional profiles, replied: see Annex III.

6 Some detailed considerations reflecting findings of the Commission's consultation are included under Annex III – point 5.

approximately 530 depositaries having their registered office in the UCITS' Home Member State (end-2002 figures). However, branch-depositaries may sometimes control significant volumes of assets, and further country-specific precisions may be needed to assess market penetration by foreign depositaries.

– Domestic competitive situations are not comparable across Member States: whilst on average, each depositary (branches included) had in charge around € 6 billion of UCITS assets at the end of 2002, national average figures ranged from approximately 1 to 40 billion euros. However raw this indicator may seem, it nonetheless illustrates very heterogeneous degrees of market concentration at Member States' level.

4.1.2 This reflects cross-border legal and prudential obstacles:

The limited number of accepted foreign institutions reflects reluctance by Member States' authorities to rely on a foreign legal and prudential system in the case of depositaries, where supervisory cooperation is not organised[7]. This reservation is exacerbated in regard to the free provision of services[8]. Most of the arguments put forward are also relevant in respect of possible freedom of establishment: the partial disconnection between the supervisory authorities in charge of the UCITS and those in charge of the depositary in a context of perceived insufficient cooperation, or the diversity of legal obligation regimes (accounting; tax; property rights on securities, etc.). Fragmentation of the European depositary market also acts as yet another obstacle to cross-border fund mergers.

4.2 The typology of eligible depositaries and related prudential standards is not harmonised

One of the first barriers to cross-border acceptance of foreign depositaries is the heterogeneous lists of eligible entities across Member States' regulations. Indeed, the depositary's legal nature, and therefore the type of prudential controls a foreign institution is actually subject to, have a bearing on the perceived level of investor protection.

4.2.1 A stricter EU typology would contribute to better acceptance of cross-border depositaries:

The variety of certain national typologies (see Annex III) should not hide the fact that, overall, credit institutions already have a leading share of the market (in eight Member States, they are the only permissible depositaries). It would therefore seem appropriate to restrict drastically the typology of eligible institutions only to those which are subject to consolidated financial supervision, or even to credit institutions –without prejudice to the possible inclusion of Central Banks. This would reflect the majority situation, facilitate supervisory cooperation and mutual recognition of prudential standards, and might even contribute to paving the way for the acceptance of the free provision of depositary services. It also seems acceptable from a political standpoint (see the replies of Member States' authorities under Annex III).

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[7] This reluctance may be mitigated by the creditworthiness of the depositary's group: competent authorities may expect the mother company to settle any legal claims with its "deep pocket" in order to prevent the depositary's reputational risk from jeopardizing the whole group's position. Under this assumption, integrated banking groups may constitute a positive development factor for cross-border depositary branching, notwithstanding other crucial issues (see below on conflicts of interests), which their organisational model may raise.

[8] Only a minority of contributors to the Commission's consultation were already favourable to such an innovation: inter alia, two national supervisory authorities, three fund manager associations and one banking federation.

4.2.2 But the dispersion of capital requirements mirrors further legal barriers:

The Commission's consultation has evidenced a strong dispersion in capital requirements:

– Across all categories of depositaries, the range is between 1 and 900 within the European Union (from approximately € 113,000 to € 100 million);

– Even within one category –credit institutions– minimum capital requirements vary from € 5 million to € 100 million.

Therefore, restricting the number of eligible categories alone would likely fail to boost cross-border depositary services. To be effective, any harmonization of depositaries' typology would need to go further into detail[9], for the following reasons:

– Overall, operating conditions for depositaries (requirements on internal organisation and resources) currently vary across the EU, even within the same prudential category (e.g. credit institutions), as reflected by the dispersion of capital requirements;

– Capital requirements also reflect the level of legal risk incurred by the local depositaries. Their dispersion across the EU reflects differences in legal obligations;

– Depositaries also need minimum financial resources to cover investments (e.g. computer systems) and meet organizational standards set by national regulations. These standards may vary in consideration of acceptable practice in a given Member State, e.g. which depositary tasks may be outsourced, and the actual criteria taken into account by supervisors. Depending on where the actual balance is set between detailed written rules and case-by-case considerations, the level of e.g. own funds may have more or less critical importance.

4.3 Cross-border provision of depositary services is hindered by diverging liability regimes:

4.3.1 Legal uncertainty has a cost borne by investors:

Two major obstacles hinder the assessment of a depositary's liability across the EU: first, the diversity of legal regimes, since the 1985 Directive refers to the laws of each Member State; second, the sometimes uncertain limits of such liability. In several Member States, although the scope of the depositary's minimum responsibilities is in theory harmonized by the Directive, their legal nature, their implementation and sanctions are not entirely fixed.

Depending on the Member State, the depositary may be subject to an obligation of result, or an obligation of means, in the performance of its prudential duties. This has a direct impact on legal certainty. For example, only three Member State competent authorities seem to exclude "*force majeure*" as an extreme waiver of responsibility.

Legal uncertainty also results from the commingling of depositary-specific legal obligations and the broad civil case law. This is especially the case in jurisdictions, where the principle of the depositary's liability according to the Directive ("*unjustifiable failure to perform ... or*

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[9] Some Member States in favour of further tightening of the typology would also support harmonised requirements on resources and internal organisation.

improper performance") is, explicitly or not, subject to limitations or derogations. Retail investors actually bear a risk (and costs) which are *a priori* hidden to them.

Furthermore, existing investor compensation schemes may not always guarantee that the prejudice will be entirely covered. In certain legal systems, failing detailed contractual provisions, the sharing of the compensation burden between fund manager and depositary will depend on settlements motivated by reputational concerns, –not by legal prescriptions. This is sometimes considered as unpredictable. In the absence of a firm delimitation of legal risk, supervisors will rely on the resources of the group, in preference to developing the market for external insurance cover, which seems unlikely to capture all legal risk.

4.3.2 The meaning of 'asset safekeeping' is not harmonized:

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

Across Member States, the mission of asset safekeeping may, or not, necessarily involve a custodian sub-function. Custody is subject to drastic economies of scale and requires considerable investments in computer systems distinct from those of depositary control. A second issue which differentiates Member States is whether or not the depositary is really subject to an obligation to return the assets, or may limit its liability.

4.3.3 Clarifying the link between depositary function and (sub-)custodianship:

In some Member States, depositaries may appoint a global sub-custodian. Global (sub-) custody business is shared between very few banking behemoths, which compete on trillions of euros of assets. They also compete with depositaries on the latter's value-added services. These are "peripheral" to the depositary's core prudential missions – e.g. collection of dividends, proxy votes – but may help cross-subsidize the costs of prudential oversight.

A major issue in the clarification of the depositary's safekeeping mission (pure controller or compulsory prime-custodian) is its potential impact on the quality of depositary controls. Should the depositary function be identified with a role of pure controller and completely rescinded from the custodian function, the large sub-custodians would be in a position to capture an increasing fraction of custodian fees, but also added-value activities. On the one hand, compression of custody margins, by concentration of volumes, might benefit investors. On the other hand, this might also result in price-led competition between depositaries on their core prudential function, thereby jeopardizing, on average, the quality of their daily oversight on fund managers.

4.4 Disparate organisational patterns are admitted:

Although the organisation of tasks may impact, in many cases, the depositary's operational risk, the Directive does not include detailed rules on this matter.

4.4.1 The tasks and obligations mostly reflect the missions specified in the Directive[10]:

Generally, most Member States consider they have set a precise list of tasks and obligations for UCITS depositaries. But this list is considered exhaustive only in certain Member States, which may indicate supervisory authorities have some leeway to interpret it.

4.4.2 But the list of permissible activities is not directly related to the depositary function:

The activities connected with the depositary's function often concern only a fraction of the institution's business (the dominant model being that of the "universal bank" or the multifunctional subsidiary). Most Member States appear to rely on the general list of permissible activities associated to a given type of institution (e.g. a credit institution). This leaves in a grey area those entities which, properly speaking, are not subject to a prudential regulation: here is, in practice, some leeway for a case-by-case approval by supervisors. Some Member States however prohibits certain activities in order to prevent conflicts of interests.

4.4.3 Specific provisions may affect the outsourcing of asset custody:

There are e.g. limitations on the nature of the sub-custodian or its location, or requirements on ex-ante checks regarding foreign legal regimes for securities property. Additionally, some national legislation provide for a certain degree of appraisal by supervisors.

4.4.4 The delegation of depositary duties is subject to differing supervisory approaches:

Most Member State regulations do not set a clear distinction between the depositary's administrative and accounting duties and its prudential duties. However, several Member States rule out the outsourcing of the depositary's prudential duties. At the same time, the doctrine restricting delegation to asset custody is a minority one. In between these two regulatory standpoints, supervisors appear to have considerable leeway, but supervisory approaches differ: e.g. delegation is subject to prior authorisation in five Member States, and it involves two categories of supervisors in at least nine Member States. Only one Member State has no particular procedure, e.g. preliminary formalities or monitoring of the delegation.

4.5 Conflicts of interest and prudential safeguards:

There is a striking divide in the set up of the depositary function in Europe, regarding the economic relationship between fund manager and depositary: in two Member States, the latter cannot belong to the same group as the manager. Neutralizing conflicts of interest is one of the main motivations invoked for this provision.

Two types of relationships are identified, both by Community legislation and by national regulations, as the main sources of conflicts of interest for a depositary: those with the UCITS itself and those with the management company. Whilst the Directive emphasizes the principle that depositary and management company each have to "*act independently and solely in the interest of unit-holders*", Member States have fleshed out this rule in rather different ways.

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[10] The Directive sets a distinction between the duties of a common fund's depositary (with a longer list) and those of an investment company's depositary (see Annex II). However, this asymmetry is not always reflected in national regulation: it has been considered, in many jurisdictions, that investment companies' shareholders are unable to punish the fund manager's misbehaviour and need the same degree of protection as common fund investors.

4.5.1 The UCITS - depositary relationship:

The variety of positions indicates at the same time the diversity of supervisory approaches and varying degrees of confidence in the "Chinese walls" expected from a depositary.

The depositary itself, or an affiliated entity, may often undertake an activity of investment on own account or other activities likely to create antagonism between its immediate profits and commercial interests, or those of its group, and the interest of the UCITS' investors. Against such risk, in at least eight Member States, the general regulatory provisions simply reflect the principles of the Directive.

However, different approaches coexist, regarding permissible transactions and activities. The answers to the Commission's consultation have not made it possible to conclude whether all Member States have set up a list of transactions with closely linked entities (*affiliated transactions*) to be subject to particular supervision. Clearly, in some situations, insistence on non-supervisory safeguards (e.g. conduct of business rules, disclosure) cannot suffice.

More generally, certain authorities defend the idea that no internal procedure or "Chinese wall" could be able to eliminate completely the risks of conflict of interest: hence the importance of external inspections and, in cases of possible investor prejudice, out-of-court redress rules under the monitoring of competent authorities.

However, existing supervisory inspections may have differing focuses, depending on whether they pertain to mainstream supervision of a given category (e.g. credit institutions) or specific supervision of the depositary function. The insistence on checking the latter's specific procedures and safeguards against conflicts of interest may therefore differ. Moreover, focusing on detailed regulation is not always sufficient to comprehend supervisory approaches: "unwritten rules" and the possible preference for case-by-case considerations (e.g. of the financial backing of the depositary's group) do matter.

4.5.2 A striking diversity of relations between depositary and management company:

Management companies can be independent or, quite often on the continent, integrated within a group which may comprise other relevant entities, e.g. brokers, custodians and the depositary. However, such group-integration does not follow a single model[11]. Only two Member States go as far as prohibiting common shareholding or common Board/directors membership[12]. Conversely, four Member States do not have any special provision in this field. Member States' regulations leave in some cases significant leeway to supervisors.

Additional safeguards are included in ten Member State regulations, to a varying extent. Flanking supervisory practice also differs. Overall, following rules on legal and capital links, prescriptions on the depositary's internal controls and "Chinese walls" are the most frequently reported safeguards.

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[11] Several group patterns may coexist in a given Member State: e.g. no group (independent management company); cases of traditional "captive customer basis" where a management company has to rely on the group depositary, which raises issues of internal risk management priorities; or the emergence of "contestable markets" where management companies may appoint an external depositary. The depositary function then really becomes a "profit centre" and a strategic business line.

[12] Situations can be even more complex, since nothing prevents the sub-custodian from belonging to the same group as the management company. But at least, the depositary function is less exposed to risks of conflicts of interest.

Nevertheless, in all the Member States, a management company is currently allowed to delegate a variable fraction of its functions to an entity that has close links with the depositary, or even belongs to its group. Certain competent authorities admittedly wonder about the need for harmonised safeguards on such delegation. The Commission's consultation identified 13 tasks or activities: an overview of the mosaic of possible delegations (Annex III) leads to the conclusion that, overall, a real convergence in delegations rules between fund manager and depositary is also a major prerequisite to the development of cross-border depositary services.

4.6 Further harmonisation of investor information

The vast majority of Member States do not appear to have developed more extensive rules than the Directive's provisions. However, in light of the discrepancies already identified in the present report (e.g. on depositaries' liability, organization of tasks, possible conflicts of interest etc.), there appears to be a strong need for further enhancing the quality of public information available to retail investors: contrary to institutional investors, they depend fully on third parties' diligence to apprehend the risks involved in investing in a given UCITS.

4.6.1 The rules on price information do not seem to raise major issues

UCITS depositaries are required by the Directive and national regulations to ensure that the value of units is calculated, and transactions on units are carried out in accordance with the law and the fund rules. In general, investor information on these rules, in particular calculation rules, does not appear at this stage to necessitate additional harmonisation. However, some specific risk-management points may call for further harmonisation, but they are more of concern for prudential authorities than for retail investors[13]: for example, the methodologies for evaluating derivative positions, or illiquid securities, and the respective degrees of involvement of the manager and the depositary in their setting.

4.6.2 Increase transparency on the depositary-related costs:

Retail investors do not choose the depositary, which is responsible towards them under certain conditions laid down by national law. Moreover, the costs (fees and commissions) related to the depositary stem from multiple factors, sometimes contingent, like the fund's investment policy (in particular when the depositary effectively acts as a custodian). As a result, any effort to increase comparability in cost disclosure, either for analysts or retail investors, will require: i/ disclosure of the total cost related to the depositary (including the possible hidden costs, e.g. fee-sharing agreements, of the relation between manager and depositary) and ii/ providing proper synoptic information on the organisation and the effective liability of the depositary.

4.6.3 Enhance investor information on the depositary's organisation:

The depositary may be allowed to delegate certain tasks to external partners (e.g. sub-custodians). Moreover, it may receive delegation mandates from a management company or investment company, whilst the responsibility remains entrusted to the latter: retail investors should be properly informed, at subscription stage or e.g. for the general meeting of an

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[13] Retail investors will be able to obtain, upon request, the detail of the methods for calculation and for monitoring of the risks, under the terms of new Article 24a of the Directive.

investment company's shareholders[14]. Moreover, when the fund manager and the depositary belong to the same group, which is intrinsically, by default, a source of conflicts of interest, investor information has, first, to draw their attention to this situation and, second, spell out the Chinese walls and other preventive safeguards against conflicts of interest, as well as any redress measures foreseen. In no case should disclosure be limited to a generic statement on the existence of "Chinese walls" without clarifying what can be expected from such measures.

4.6.4 Ensure proper investor information on the depositary's liability

Even market practitioners sometimes wonder about the imprecise extent of a depositary's liability. Furthermore, depending on Member States' laws, retail investors may, or not, sue directly a UCITS depositary, which may, or may not be, subject to an irrebuttable presumption of misbehaviour: e.g. what would a depositary owe, respectively, to the fund manager and to retail investors in case of a sub-custodian's winding-up?

As already pointed out, the consolidation of the Internal Market for depositary services will necessitate convergence of the depositary's liability regimes. This process will take time, without prejudice to the more urgent clarification of some of its components (e.g. the meaning of "asset safekeeping"). In the shorter term, nevertheless, enhancing investor information will simply give them a better understanding of the real costs they would have to bear, after the possible intervention of any available compensation scheme.

5. A comprehensive approach:

In accordance with the Council's request, this Communication has provided an overall review of applicable regulations in the Member States. Moreover, this Communication has also identified some crucial points where real progress is needed: the ultimate objective is to increase the efficiency of the fund management industry in Europe by consolidating the Internal Market, thereby reducing costs and risks, including those currently hidden to investors, and legal uncertainties which hinder the emergence of cross-border depositary services.

5.1 Fields of action

In the Commission's view, the following areas will require additional harmonisation:

i/ Promote better prevention of conflicts of interests:

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

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[14] This report does not deal with corporate governance in investment companies (i.e. UCITS in corporate form); the control by their shareholders of a depositary's costs and performance is just one aspect of the question.

ii/ Clarify the extent of the depositary's liability:

Promoting clarity and convergence of the depositary's liability regimes across Member States will require a common reading of the concept of "asset safekeeping" and of the specific control duties assigned to the depositary.

iii/ Promote convergence of initial and operating conditions and, in particular, capital requirements:

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

iv/ Enhance transparency standards and investor information:

This should be the highest short-term priority and help put pressure on existing discrepancies. Enhanced public information standards should cover: the organisation of the depositary's tasks; measures taken against conflicts of interest; the depositary's liability; all the costs connected to the depositary's services.

5.2 A step-by-step approach

Work should begin with EU regulatory experts to develop: first, standards on investor information and conflicts of interest; second, standards on the depositary's missions, resources and liability.

The Commission will take stock of the results of this work, especially by assessing the need for possible legislative measures to achieve necessary harmonisation where appropriate. The Commission's conclusions will be fed into two reports:

- A chapter on depositary issues will be attached to the **2005 overall UCITS Report** requested from the Commission under Article 2 of Directive 2001/108/EC. This sub-report will address **two questions**:

    - Whether and how the relationship between fund manager and depositary may be better regulated by EU legislation, especially insofar as preventing conflicts of interest is concerned;

    - Whether and how the typology of eligible depositary institutions, and consequently their missions and resource requirements, might be needed to be harmonised by EU legislation.

- A **subsequent report** will review progress on the above-listed points and on the use of the existing branching possibility for cross-border provision of depositary services. This report will evaluate whether there is a need for expanding, through EU legislation, cross-border opportunities for a full European passport for EU depositaries (branching under sole Home MS responsibility and free provision of services).

5.3 Timetable:

	Output:	**Time:**
EU regulatory experts (liaising with the Commission)	Standards on investor information and conflicts of interest	By early 2005
EU regulatory experts (liaising with the Commission)	Standards on the depositary's missions, resources and liability	By mid-2005
Commission	Chapter on UCITS in 2005 overall UCITS report to the European Parliament and the Council	By mid-2005
Commission	Conclusive depositary report	By early 2006

ANNEX I

Glossary:

UCITS (legal form): depending on the jurisdiction, UCITS can be constituted either under the law of contract (as *common funds*), or trust law (as *trusts*), and (also) under statute, i.e. in corporate form (as *investment companies*). The Directive may refer to both non-corporate forms under one designation, e.g. "common fund" or "unit trust". Importantly, some Member States' legal frameworks are limited to common funds, i.e. all their UCITS are without legal personality and depend on a designated external fund manager (a management company).

UCITS' fund manager: either a *management company* or a "*self-managed investment company*". Unlike common funds or unit trusts, corporate UCITS, i.e. investment companies, may bring together a vehicle (the fund) and a fund management capacity into the same entity. In that case, Directive 2001/107/EC has clarified that they should be referred to as "*investment companies which have not designated a management company*" in their instruments of incorporation – i.e., self-managed investment companies. In this Communication, most of the remarks concerning the "fund manager" or "management company" should also be deemed to apply to self-managed investment companies, except that these may not receive any task under a delegation mandate, e.g. from the depositary.

UCITS depositary: it is simply defined by the Directive as an entity entrusted with specific prudential missions and subject to a number of other general provisions (see under point 2.2 above and Annex II). The UK regulatory designation is twofold, according to whether these missions have to be achieved with regard to unit trusts (by a *"trustee"*) or with regard to an investment company (by a *"depository"*). However, for the reader's convenience, only the term "depositary" has been used in this Communication.

It should also be noted that the specific regulatory meaning of the designation "UCITS depositary" is precisely based on the peculiar nature of these missions and obligations and, more generally, of the provisions drawn up under UCITS national regulation from Community law[15]. The scope of the concept of "safekeeping" of assets, to which it is particularly related, has thus to be considered in this specific context (see under point 4.3.2).

Central Securities Depositary (CSD)*: an entity entrusted with the safekeeping and administration of securities, which enables securities transactions to be processed by book-entry, and may moreover have clearing and settlement functions. Among the findings of the Commission's Consultation is also the fact that in certain Member States, CSDs are explicitly listed in the typology of sub-custodians to which a UCITS depositary may entrust, under certain conditions, all or part of the assets under its safekeeping.

Custodian*: an entity entrusted with the safekeeping and administration of securities and other financial assets on behalf of others, and may moreover provide additional services, including clearing and settlement, cash management, foreign exchange and securities lending.

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[15] An institution which acts as UCITS depositary may also carry out parallel activities on account of collective investment undertakings, which are not covered by the UCITS Directive ("non-UCITS"); there are moreover some 'depositaries' which are specialised in non-UCITS, and are not necessarily subject to the same prudential rules and duties.

An entity which is entrusted by a custodian with a fraction of the assets under its nominal custody is a **sub-custodian**.

Global sub-custodian*: a sub-custodian which provides its client, here the UCITS depositary (legal keeper of the assets), with custody services in respect of securities traded and settled on markets of various countries, through its own network. The global sub-custodian is a single interlocutor providing a range of services which may well overlap with those that the UCITS depositary may itself provide to the UCITS fund manager beyond its core missions of prudential control.

(*) For more details, see:

- the European Central Bank's Blue Book on "*Payments and Securities Settlement Systems in the European Union*" (June 2001), incl. the glossary;

- the Second *Report of the Giovannini Group on Clearing and Settlement Arrangements in the European Union*, April 2003.

ANNEX II

The depositary's missions and liability:

1. The depositary's missions according to the 1985 directive:

1.1. Safekeeping the assets of the UCITS:

Article 7(1)-(2) for the common fund's depositary (respectively, Article 14(1)-(2) for the investment company's depositary) read:

1. *A unit trust's assets* [respectively, *An investment company's assets*] *must be entrusted to a depositary for safe-keeping*.

2. *A depositary's liability as referred to in Article 9* [respectively, *in Article 16*] *shall not be affected by the fact that it has entrusted to a third party all or some of the assets in its safe-keeping.*

1.2. The other missions:

They are listed under Article 7(3) for the common fund's/unit trust's depositary (respectively, under Article 14(3) for the investment company's depositary):

Article 7(3) (common fund / unit trust):

A depositary must, moreover:

(a) *ensure that the sale, issue, re-purchase, redemption and cancellation of units effected on behalf of a unit trust or by a management company are carried out in accordance with the law and the fund rules;*

(b) *ensure that the value of units is calculated in accordance with the law and the fund rules;*

(c) *carry out the instructions of the management company, unless they conflict with the law or the fund rules;*

(d) *ensure that in transactions involving a unit trust's assets any consideration is remitted to it within the usual time limits;*

(e) ensure that a unit trust's income is applied in accordance with the law and the fund rules.

Article 14(3) (investment company):

Obligations spelled out in the first, fourth and fifth points above (letters "a", "d" and "e").

2. The depositary's liability in the 1985 directive:

It is covered by Article 9 for the common fund's depositary (respectively, Article 16 for the investment company's depositary).

Article 9 (Common funds):

A depositary shall, in accordance with the national law of the State in which the management company's registered office is situated, be liable to the management company and the unit-holders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them. Liability to unit-holders may be invoked either directly or indirectly through the management company, depending on the legal nature of the relationship between the depositary, the management company and the unit-holders.

Article 16 (Investment companies):

A depositary shall, in accordance with the national law of the State in which the investment company's registered office is situated, be liable to the investment company and the unit-holders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations, or its improper performance of them.

3. Provisions examined by the Council Working Party:

Proposed in the autumn 2000, the addition of such provisions was ruled out pending further evaluation of the need to further harmonisation in this field.

SECTION IIIa

Obligations regarding the depositary

Articles 7 and 8 shall be modified as follow.

1.-at the end of article 7 paragraph 2: "the Depositary shall not delegate its functions of control of the UCITS" and

-at the end of this article: "The description of the functions of the depositary is detailed in Annex III."

2. The following sentence shall be added at the end of Paragraph 2 of article 8:

"It must communicate to the UCITS competent authority a programme of activity setting out, inter alia, its organisational structure and its procedures. The depositary must have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms. It must communicate to the UCITS competent authority any information required to monitor compliance with the above conditions on a continuous basis.

Proposed Annex III:

Bookkeeping of Custody accounts:

– accounting for cash accounts and securities accounts in the name of the UCITS;

– safekeeping of assets and their transfer on demand of the UCITS, according to the measures laid down by the market authorities;

– settlement of instructions from the management company;

– clearing of derivatives instruments traded on regulated markets;

– payment of dividends and income on assets held in the name of the UCITS;

– processing corporate actions on these assets;

– tax treatment linked to the UCITS;

– centralising purchases and redemptions when the UCITS is not listed on a market.

Compliance:

The Depositary shall check the compliance with, and ensure the respect of the management company of, the:

– prudential investment rules;

– investment policy set out in the information sheet or the prospectus;

– regulatory framework applying to UCITS;

– rules for calculating the value of UCITS units;

Furthermore, the Depositary ensures control of respect of the legal formalities of the UCITS.

ANNEX III

Main lessons of the consultation carried out by Commission services on the regulation of UCITS depositaries in the Member States:

1. Background:

The consultation [16] was launched on 5 September 2002, and was closed on 19 November after receipt of the very last answers from some Member State supervisory authorities. Overall, the Commission services received 97 answers.

Not all respondents answered the full set of questions: in general, more than 80 contributions were made on each of the Sections A to F (regulatory issues), but in several cases contributors only provided few answers per Section. Moreover, in a number of cases, very similar, if not identical responses were made by several institutions. Under these conditions, it is important to consider with precaution the data resulting from the aggregation of all the answers collected through the consultation.

Against this background, the presentation which follows, after introducing a typology of contributors, will illustrate some of the main lessons of the consultation from a regulatory point of view (based the answers provided by the competent authorities of the 15 Member States).

2. The contributors' professional typology:

The consultation made it possible in particular to collect, *inter alia*, the views of the competent authorities in the 15 Member States.

A second substantial category of contributors comprises those professional bodies, which felt concerned with the consultation at Member State-level:

- ten national fund managers associations;

- one savings bank associations;

- five national banking federations;

- two national depositary association;

- two specific contributions from a national Chamber of commerce and an association of finance companies.

Some 60 remaining answers were made by "market practitioners" (even though not all such contributors labeled themselves as such):

– close to 40 replies concerning the depositary activity as such (official replies on behalf of depositary institutions and additional replies by bank managers);

– 9 replies by fund managers;

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[16] The text (in Word format) is available at the following address: http://europa.eu.int/comm/internal_market/en/finances/mobil/ucits/2002-consult/index_en.htm

– 3 replies clearly identified as contributing the viewpoint of a credit institution exclusively outside the depositary business;

– one reply by a law firm;

– one reply by an audit company;

– additionally, a half-dozen replies coming from credit institutions combining various profiles.

At European level, off-line contributions were made on behalf of the European fund managers association (FEFSI) and a cross-national retail investors' association.

It is also worth noting, first, that no natural person involved in depositary activities replied to the consultation (although it appears this is legally possible in at least one Member State, based on contributions by supervisory authorities)[17]. Second, no retail investor contributed as such to the consultation.

All in all, a majority of responses were contributed by practitioners who are involved in various respects in depositary matters and hence may have varying degrees of knowledge of the legal issues raised in the questionnaire; this may help understand why ten contributors had reservations ("expectations not met") on the questionnaire; eight of them clarified their grounds:

- not relevant ("irrelevant in content"): 4 answers;

- too complicated ("too difficult to understand"): 2 answers;

- too long: 1 answer;

- too much technical: 1 answer.

Approximately 90% of on-line contributors were satisfied with the content of the consultation.

3. Geographic breakdown of the contributions:

Four Member States account for approximately 61% of the contributions.

LU	FR	EL	UK	AT	BE	DE	ES	IE	IT	SE	PT	DK	FI	NL	Others
26	14	9	9	5	5	4	4	4	4	4	2	1	1	1	4
26.8%	14.4%	9.3%	9.3%	5.2%	5.2%	4.1%	4.1%	4.1%	4.1%	4.1%	2.1%	1.0%	1.0%	1.0%	4.1%

[17] Some contributors (bank managers) did mention "natural person" as their field of activity (due to a misunderstanding on the meaning of the question concerned, which was not referring to a particular status of the natural person responsible for the depositary business within the depositary institution). Due to this and other slightly erratic answers, data had to be reprocessed for statistical treatment of aggregated answers.

4. Some of the main lessons drawn from the contributions made by Member States' authorities:

4.1. Concentration varies –and cases of branch-depositaries remain limited:

	Cases where the depositary has his **registered office** in the Member State where the UCITS was authorised	Cases where the depositary only has a **branch** in that Member State	Overall assets of UCITS authorised in that Member State, in billion euros *	*p.m: Overall assets of investment funds (UCITS and non-UCITS) authorised in that Member State, in billion euros* *
BE	**13**	**2**	**71.5**	***77.2***
DK	**15**	**2**	**38.3**	***38.3***
DE	+/- **80**	**2**	**199.5**	***751.0***
EL	**15**	**none**	**25.4**	***27.1***
ES	**118**	**5**	**170.8**	***172.9***
FR	**87**	**none**	**805.9**	***889.3***
IE	**23**	**5**	**238.5**	***303.9***
IT	**48**	**2**	**360.7**	***371.0***
LU	**65**	**6**	**766.5**	***844.5***
NL	**0****	**none**	**10.0*****	***106.3***
AT	**22**	**1**	**63.8**	***85.3***
PT	**17**	**1**	**19.0**	***24.5***
FI	**12**	**2**	**15.7**	***17.7***
SE	**< 10**	**1**	**55.3**	***56.1***
UK	**7**	**none**	**275.5**	***370.2***
TOTAL	**+/- 530**	**+/- 30**	**3,116.4**	***4,133***

* FEFSI data covering the situation at the end of Dec. 2002 (except NL: at the end of Dec. 2001). The data (UCITS + non-UCITS) are provided as a mere illustration of the relative importance of UCITS' assets at national level. It is important to note that the end-2002 figures reflect, in particular, the impact of the bear market for stocks, depending on the importance of UCITS' investments in equities (which varies significantly across Member States).

** The UCITS authorised in The Netherlands are all listed investment companies, which are not subject to the requirement to have a depositary: this is an option left to Member States' discretion by Article 14(5) of Directive 85/611/EEC, --subject to some limitations on grounds of investor protection.

*** End-2002 estimate (source: Dutch FMA)

4.2. Current typology of eligible institutions and preferred possible future typology:

	Regulators' preferred target typology:	**Current regulation (**with an indication of specific minimum capital requirements, where relevant):
BE	Credit institutions and investment firms, both subject to additional organizational and capital requirements; Central Bank	Credit institutions, investment firms, public institutions (e.g. Central Bank)
DK	Credit institutions only	Credit institutions
DE	Credit institutions only	Credit institutions
EL	Supervised institutions in general	Credit institutions
ES	Institutions subject to prudential supervision by the central Bank or the Financial Markets Authority	Credit institutions, investment firms
FR	Supervised institutions in general	Credit institutions, investment firms, insurance undertakings, public institutions (e.g. Central Bank); min capital requirement: 3.8 million euros
IE	Supervised institutions in general	Certain credit institutions (min. cap. 6.35 million euros) + wholly-owned subsidiaries of credit institutions (incl. those of equivalent institutions in third countries) subject to "financial resource requirements" of at least 125,000 euros (or one year's fixed overheads), incl. by means of a subordinated loan assessed by supervisory authorities
IT	____	Credit institutions (min. cap. 100 million euros)
LU	____	Credit institutions (min. cap. 8.7 million euros, including 6.2 million euros of paid-up share capital)
NL	No restriction to specific categories (insofar as the activities of securities safekeeping and administration on account of third-parties are subject to supervision)	Credit institutions + other categories (securities administration firms, certain trusts, independent firms); min. cap. 113,445 euros
AT	Credit institutions only	Credit institutions
PT	Credit institutions only	Credit institutions (min. cap. 7.5 million euros)
FI	Supervised institutions in general	Credit institutions, investment firms, other regulated legal persons
SE	Credit institutions only	Credit institutions
UK	Supervised institutions in general	Credit institutions, investment firms, insurance undertakings, other regulated legal persons; min. cap. £ 4 million.

4.3. On the basis of a list of 13 functions identified in the consultation, possible delegations by the management company to the depositary:

Shaded box: **functions identified as eligible for possible delegation to the depositary** in a given Member state

	Unit issue and redemption	marketing	Valuation and pricing (incl. tax returns)	Legal and fund manag.[mt] accoun-ting services	Customer enquiries	Regulatory compliance monitoring	Mainte-nance of unit-holder register	Distribu-tion of income	Record keeping	Contract settlement (incl. certificate dispatch	Invest-ment mana-gement	Internal control Funct-ions	Risk-manage-ment proce-dures	Precondi-tions / other functions
DK														
DE	Depositary		(ascribable to the depositary by contract, not by a delegation)			Depositary								
EL														
ES	shared	shared						shared		shared				
FR														
IE														
IT	Depositary							Depositary		Depositary				
LU														
NL														
AT														
PT														
FI														
SE														

NB: BE and UK did not supply any detailed answer to this question.

"Depositary": function considered as being immediately under the depositary's responsibility; "shared": function for which the responsibility is shared between the trust company and the depositary, depending on the precise tasks that it covers.

Furthermore, pursuant to Directive 2001/107/EC, Member States may also allow UCITS management companies to provide the following "non-core service": safekeeping and administration in relation to units of collective investment undertakings – which could modify the allocation of tasks between depositary and management companies in some jurisdictions

5. Some further comments related to differences in the depositary's legal frameworks:

5.1 Prudential issues related to the interpretation of 'asset safekeeping'

5.1.1 Limitations to the depositary's liability:

The issue is whether or not the depositary is really subject to an obligation to return the assets in any events (except limited cases of "Acts of God" or really exceptional circumstances left to the court's appraisal). When other legal or contractual limitations are accepted, the depositary tends to assume a role of sub-custodians' controller, i.e. it may be able to waive its liability even in the event of bankruptcy or fraud of a sub-custodian provided it can prove it exerted controls with "reasonable diligence".

5.1.2 Prudential concerns on the link between depositary, sub-custodian and UCITS:

Even as a prime custodian, the depositary may entrust assets to sub-custodians, or even to a single global sub-custodian, whose network will handle for it the relationships with each country-specific central depositary (CSD). The depositary will then concentrate its counterparty risk on one partner institution: this possibility is admitted in at least nine Member States. Another type of relation, admitted in at least three Member States, consists in the direct opening of an account by the UCITS with a sub-custodian. This situation raises specific prudential issues in terms of effectiveness of depositary oversight.

5.2 Impact of the distinction between obligation of means and obligation of result:

Depending on the Member State, the depositary may be subject to an obligation of result, or an obligation of means, in the performance of its prudential duties. For instance, to "*ensure that the value of units is calculated in accordance with the law and the fund rules*" may translate into two dramatically different levels of responsibility and computer-technology investments: the depositary may either have to control the calculation methods (through sample-checks and credibility tests based on indices) or be subject to a duty to achieve the same result (with a systematic recalculation of positions).

5.3 Some examples of sources of conflicts of interest and existing regulatory safeguards:

5.3.1 Cash deposits:

Cash deposits by a UCITS with its depositary are common market practice. One UCITS competent authority reportedly uncovered, through on-site inspection of the depositary, the existence of unfair contracts, where the UCITS was remunerated below market conditions.

5.3.2 Sharing of registered office between depositary and management company:

Only a minority of Member States seem to have included in their regulations a ban on the depositary and the management company sharing the same registered office: prevention of a major conflict of interest would then rest on the requirements and "unwritten" prohibitions directly imposed by supervisors.

5.3.3 Some further comments on the matrix of delegation possibilities provided under point 4.3 of this Annex:

Based on the replies of competent authorities, it seems that in at least one Member State, a management company could delegate all its tasks, except for internal controls (but including risk-management procedures); in four other Member States, it may delegate 7 to 10 of the functions concerned. Except for risk-management, all other tasks were mentioned by at least two regulators as eligible for such delegation (including internal controls and investment management)[18].

[18] Furthermore, the lead responsibility for a given task may sometimes be allotted alternatively, depending on the Member State, to the management company or the depositary (but with the further possibility of delegation to the other, depending on regulatory and contractual provisions).