



Brussels, 17.12.2015  
SWD(2015) 292 final

**COMMISSION STAFF WORKING DOCUMENT**  
**EXECUTIVE SUMMARY OF THE 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**

{C(2015) 9160 final}  
{SWD(2015) 293 final}

## 1. INTRODUCTION

UCITS funds are marketed in Europe as well as in Asia and South America, resulting in a steady rise in UCITS asset under management over the years: from €5,694 billion as of the end of 2010 to EUR 6,455 billion as of the end of 2013 to EUR 7,514 billion as of the end of 2014.

The UCITS Directive requires that each UCITS fund appoints a depositary. The depositary, usually a credit institution, has to control title of any assets bought by the fund, keep the assets in custody or, where custody is not possible, keep records proving the UCITS' ownership of the investment assets.

UCITS depositaries are also tasked with a series of oversight functions, 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 (legal oversight).

The largest UCITS depositaries are large international banks or their subsidiaries. In addition to the services mentioned above, depositaries provide custody (safekeeping) services to investment funds (UCITS and AIFs). Depositaries also provide additional (ancillary) services such as securities lending, brokerage and execution of foreign exchange trades.

Custody is the only depositary function that can be delegated to third parties. Delegates that exercise custody are usually themselves credit institutions. Delegation is a tool used by those depositaries that do not have a network that covers a particular investment domicile.

The UCITS management company is responsible for ensuring that each UCITS has a depositary. According to 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. In practice, many UCITS asset managers and UCITS depositaries are part of the same corporate (banking) group.

Asset managers that belong to a banking group, especially in smaller Member States or in Member States with a smaller UCITS segment, 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 place assets in custody with a depositary outside the group, usually an international bank that has a large geographical custody network.

UCITS V intends to align depositary requirements with the 2011 Alternative Investment Fund Managers Directive (AIFMD). Alignment covers all essential aspects, such as the 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 described below, are identical to the ones that were foreseen by the AIFMD.

## **2. PROBLEM DEFINITION**

According to the reformed UCITS Directive (UCITS V), a UCITS depositary must either be a national central bank; a credit institution authorised in accordance with Directive 2013/36/EU or another legal entity, authorised by the competent authority under the law of the Member State to carry out depositary activities under the UCITS Directive.

The UCITS V empowerments aim to provide further detail on the depositaries oversight duties, delegation arrangements with respect to the custody of UCITS assets and the requirement that both the management company and the depositary act independently of each other.

The UCITS contains two additional empowerments (1) steps that a depositary has to ensure that a third party takes to provide for insolvency protection of UCITS assets and (2) the independence requirement.

It results from the above that the empowerments concern three distinct entities: the UCITS management company, its depositary and third parties to whom custody is delegated.

## **3. ANALYSIS OF SUBSIDIARITY**

In exercising the above mentioned empowerments, due account was taken of the principles of subsidiarity and proportionality. In an integrated market for investment funds, UCITS are sold to professional but also retail investors across the EU. This makes a uniform set of rules governing UCITS depositaries indispensable. The UCITS rules aim to ensure that UCITS investors, who can be reside across the EU, enjoy the same level of protection when investing in a harmonised UCITS fund. This is why uniform rules on the safe-keeping of investment assets with a UCITS depositary are crucial.

Equally, the relationship between a UCITS management company and a UCITS depositary/third party custody delegate is governed by uniform rules, avoiding conflicts of interest which can prove detrimental to retail investors across the EU.

Action at national level would not achieve the intended result of ensuring a uniform standard of investor protection and protection against potential conflicts of interest between the UCITS management company and the depositary/third party. A "mapping" of national measures concerning the relationship between the UCITS manager and its depositary conducted by ESMA revealed that national rules governing this relationship are different in scope and rigour and that in some cases no measures to ensure independent action between the two entities were in place.

This divergence in national approaches explains the co-legislators' decision to empower the Commission with the task of further specifying and harmonising rules that govern the relationship between the UCITS manager and the UCITS depositary/third party.

#### **4. OBJECTIVES**

The proposed delegated acts aim to achieve: (1) clarity the delegation arrangements that a UCITS depositary may enter into to ensure custody of UCITS assets as well as (2) avoidance of conflict of interest between a UCITS management company and its depositary or the custody delegates of the depositary.

The impact assessment analyses a series of investor risk that could materialise if the roles of asset management and safekeeping of investment assets were not conducted in an independent manner.

The same is true for delegation arrangements concerning the custody of UCITS investment assets. The rules concerning on the selection of a delegate and the continuous monitoring of the delegate's activities form an essential safeguard against the loss of these investment assets and, in turn, the avoidance of investor detriment.

#### **5. POLICY OPTIONS**

##### *Delegation arrangements*

The delegated act will define the necessary steps that a UCITS depositary has to take when delegating custody of UCITS investment assets to a third party. While the delegated act mirrors a series of due diligence measures that have to be adhered to as part of the delegation arrangements as well as during the entire lifetime of these arrangements in the AIFMD, an additional requirement was considered in order to enhance the protection of UCITS investors. This stems from the fact that UCITS, as opposed to AIFMD, is a retail investor scheme.

The additional requirement considered necessary for the UCITS framework (this requirement is absent in AIFMD) was the obligation to obtain an independent legal opinion on the protection of UCITS assets in case of the insolvency of the third party. In order to be proportionate, this requirement is only considered when the third party delegate is domiciled in a third country outside the European Union. With respect to delegations within the Union, special rules on the "insolvency-proofing" of investment assets, directly addressed to the Member States, already apply by virtue of UCITS V.

The requirement to obtain an independent legal opinion on the protection of UCITS assets in case of the delegate facing insolvency aims to ensure that UCITS assets are protected against distribution to the third party's creditors throughout the pendency of the delegation arrangements. In light of the fact that many UCITS investment assets are domiciled and held in custody in third countries, the envisaged legal safeguard is deemed crucial for investor protection.

The alternative, allowing this legal opinion to be furnished in-house, would provide a lower level of legal certainty. This is because independent lawyers would not face a conflict of interest in concluding that certain jurisdictions the UCITS wishes to invest in do not provide the requisite level of asset segregation and insolvency protection.

##### *Independent action*

With respect to the independent action of a UCITS management company and its depositary or a third party delegate, the delegated act faced the choice between requiring a full structural

separation between a UCITS management company and its depository/third party and safeguards linked to the members of both entities' management and supervisory boards.

A full structural separation would have entailed: (1) the prohibition of all cross-shareholdings between the management company and its depository or (2) the prohibition that management/investment company and its depository/third party custody delegate belong to the same corporate group.

The alternative choice consists in a series of requirements as to the composition of the management or supervisory bodies of both the management company and the depository/third party custody delegate. Most importantly, the alternative choice would prohibit any overlap between the members of each entity's management bodies. In case the entities have a management board which is different from the supervisory board, this "no overlap" requirement would be relaxed (as the potential for conflicts of interest is lower if the management board does not have a supervisory function): in this scenario not more than one third of the members of the supervisory board can be identical to those on the supervisory or management board of the other entity.

Additional requirements would apply in the situation when the management company and the depository/third party custodian are part of the same corporate group. In these cases, additional safeguards apply so that members of the management/investment company cannot exercise decisive influence over the governing bodies of the depository/third party and vice-versa. Such safeguards would include rules requiring that at least one-third or 2 members, whichever is the lesser, of one entity's board should have no personal or contractual links to the other entity.

For the cross-shareholding and group scenario, there would also be rules on the selection of the depository and safeguards on how potential conflicts of interest between "group" companies and affiliated company are managed.

## **6. ASSESSMENT OF IMPACTS**

The obligation to obtain independent legal advice on the insolvency laws that govern the jurisdiction in which the third party delegate is domiciled does not impose a major burden on a depository. Obtaining legal advice on the applicable laws and jurisprudence in the country of the delegate – the country where the investment assets are located – already forms part of the due diligence that is incumbent on a UCITS depository. The additional cost of obtaining legal advice from an independent source is marginal. The marginal additions can, furthermore, be pooled by obtaining advice on particular jurisdictions through an intermediary (a trade association). This would spread the cost of obtaining the opinion among several members of an association.

The obligation to ensure independent management or supervisory boards may involve some cost in nominating new members to such boards which are not already on the other entities board. Also, the requirement that management company and depositories/third party that belong to a single corporate group must ensure that at least a third (or two) members of both entities' board are not affiliated with either the other entity or the group may entail additional cost of nominating new directors.

The costs of appointing independent members are estimated as being at least €3.765 billion<sup>1</sup>

These costs are far inferior to the cost of the other alternative that was assessed to ensure independent behaviour: full structural separation between the two entities. Structural separation would have proven more costly as it would have required all assets held in custody within a corporate group to be handed over to an eligible depositary that does not belong to the corporate group. Quantitative details on the assets concerned by such a transfer of custody - approximately a third of the € 8 trillion UCITS assets held in custody in the EU - as well as the cost induced by such a move would entail for individual operators are described in the impact assessment.

In particular: according to data submitted to the Commission's services by various stakeholders reallocation of custodial UCITS assets outside a corporate group would affect at least €2.5 trillion that are held in custody within a group in the European Union. This would amount to for at least 32% of European UCITS assets. Moreover, structural separation would have a disproportionate impact on smaller Member States or Member States with smaller UCITS markets. In smaller Member States at least 56% of the UCITS assets are held in custody within a corporate group.

Operators in smaller Member States would also face challenges in reallocating assets to a structurally separate depositary as there might be no local alternatives available (a depositary and a fund must be domiciled in the same Member State).

The cost of transferring assets to another custodian would be at least €75,000 per billion of assets transferred. As more than 2.5 trillion will have to shift, and assuming that cost increases are linear, the overall cost can be estimated at around €187,500 million.

## **7. COMPARISON OF OPTIONS**

As the additional cost of obtaining legal advice from an independent source is marginal and can be pooled by obtaining advice on particular jurisdictions through an intermediary (a trade association), preference is given to the policy that requires an independent legal opinion.

With respect to ensuring independent behaviour of the management/investment company and the depositary/third party, the cost of requiring independence of management or supervisory boards as opposed to a full structural separation between a UCITS management company and a UCITS depositary militate in favour of the less costly choice.

The chosen options are proportionate. The advantage on requiring independence of management or supervisory boards as opposed to a full structural separation between asset managers and depositaries allows smaller corporate entities to continue providing both asset management and the depositary function within the same group. As described in the impact assessment, smaller operators can often only maintain the minimum efficient scale of custody because the group's asset manager designates a group entity as their depositary.

In order to ensure that the chosen policy takes into account the reduced potential for conflicts of interest when management companies have chosen a depositary /third party delegated that does not operate within the same corporate group or is not linked to the management company by cross-shareholdings, the chosen policy will differentiate between three scenarios:

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<sup>1</sup> Estimation is based on the figure provided by Ireland, France, Luxembourg and United Kingdom which represent more than 80% of the UCITS market

**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>2</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);

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.

## **8. MONITORING AND EVALUATION**

Monitoring of the new rules will become part of the regular monitoring of the UCITS Directive and will be conducted in close cooperation with ESMA.

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<sup>2</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.