

***UCITS V***  
***The Depositary's Role  
and Managers'  
Remuneration***

February 2011

## Executive Summary

The European Commission (EC) is currently consulting on proposed changes to the role of UCITS depositaries and the remuneration of UCITS managers, to address perceived failings, better protect investors and align UCITS funds with the measures instituted for alternative investment funds under the Alternative Investment Fund Managers Directive (AIFMD). The depositary role would be strengthened by expanding its oversight responsibilities, increasing its liability and shifting the burden of proof onto the depositary for negligence or intentional failure to perform its duties. The remuneration measures proposed largely follow the trend seen in the banking industry and under AIFMD, seeking to more closely align the interests of financial services industry players to those of investors. These changes have significant implications for UCITS managers, depositaries, third party administrators, investors, auditors, and regulators.

### Depositaries

The Madoff fraud and the Lehman Brothers insolvency have focused regulators' attention on the depositary role. In addition to safekeeping assets, depositaries are required to ensure that all transactions (e.g. subscriptions, redemptions and cancellations of units) affected by or on behalf of UCITS funds are carried out in accordance with the law and the fund documentation. Crucially, depositaries must act independently and solely in the interest of the unit-holders to effectively discharge this role.

#### Single depositary requirement:

The new rules would require UCITS to appoint a single depositary to be entrusted with safekeeping of all the fund's assets. The depositary must be in a position to have oversight and responsibility for all assets and cash transactions for the fund.

#### Depositary duties:

- **Definition of safekeeping:** The EC proposes to define the activities and responsibilities related to safekeeping in a manner consistent with AIFMD.

The regime would distinguish between safekeeping physical custody of financial instruments (e.g. securities) and asset monitoring duties relating to assets that are not physically held (i.e. financial instruments that may only be followed through a position-keeping book).

- **Alignment of oversight functions:** Under the current framework oversight duties vary depending on the legal form of the UCITS, the location of the Depositary and depositaries of funds with a corporate form such as an investment company which have less onerous oversight duties than for funds which are unit trusts. The EC proposes to extend the current duties of depositaries for UCITS with a corporate form to all forms of UCITS.
- **Delegation:** The proposal aims to restrict delegation of depositary tasks to safekeeping duties, and to align the conditions and requirements for such delegation with those of AIFMD.

#### Depositary liability regime:

**Liability:** The proposal clarifies the difference between a depositary's "unjustifiable" failures to perform duties and circumstances in which a failure to perform may be justifiable, to address the depositary's liability in cases when a UCITS suffers a loss as a result of the depositary's negligence or intentional failure to perform its duties. A strict liability regime was debated in the AIFMD drafting process but ultimately rejected, and that is not being consulted on for UCITS. However, depositaries are likely to face additional costs, due to increased potential liability for their own actions and those of their subcustodians, which will need to be borne by the UCITS and their investors.

**Replacement of lost assets:** Depositaries would be obliged to return the identical financial instruments or a corresponding amount of assets (where fungible) to the UCITS in case of loss.

**Scope of depositary liability for assets lost by a sub-custodian:** Depositaries would remain liable for the loss of assets, even where part or all of its safekeeping tasks have been delegated to a third party.

**Burden of proof:** The depositary would bear the burden of proof in demonstrating that it has performed its duties to the required standard, in situations where negligence or intentional failure to perform its duties are alleged.

### *Investors' rights of action against the depositaries:*

The new proposal aims to give the same rights to all UCITS investors, allowing them to sue depositaries, either directly or indirectly through the management company, depending on the legal nature of the relationship between the depositary, the management company and the investors.

### **Eligibility criteria:**

An exhaustive list of entities eligible to act as UCITS depositaries would be introduced, including credit institutions, MiFID firms which also provide the ancillary service of safe-keeping and administration of financial instruments, and existing UCITS depositary institutions (by means of a grandfathering clause).

### **Certification requirements:**

A requirement for an annual certification of the assets held in custody by the depositary, which could be performed by the depositary's auditors would be introduced.

### **Investment companies:**

The UCITS Directive currently allows Member States to exempt investment companies from the requirement to appoint a depositary, but this exemption would be removed.

### **Passporting:**

The EC is not planning to introduce a depositary passport at this point but intends to assess the need for this a few years after the new UCITS depositary framework comes into force.

## ***Remuneration***

The EC believes that remuneration for UCITS managers should be more clearly aligned to investors' interests and supported by robust policies and procedures. It intends to introduce measures similar to those under AIFMD.

### **Remuneration structures:**

UCITS managers remuneration structures would be required to include:

- Criteria for calculating compensation for different categories of staff where remuneration is performance related;
- Rules for guaranteed variable remuneration;
- Rules for fixed and variable components of total remuneration;
- Rules on pension benefits; and

- Rules for payments related to termination of employment.

*Scope:* Remuneration policies would apply to staff whose professional activities may have a material impact on the risk profile of the UCITS, specifically to senior management including the board of directors, persons carrying out supervisory functions or the permanent risk management function, and other employees in the same pay bracket as senior management.

*Governance:* The manager's board of directors (or equivalent) would be required to adopt the remuneration policy, and be responsible for the implementation and periodic review. Larger managers would be required to establish a remuneration committee to exercise independent judgement on remuneration policies and practices. Also, the compliance function would have to review how the policy operated in practice at least annually.

*Effective risk taking and preventing conflict of interests:* UCITS managers' remuneration policies should be designed to promote sound and effective risk management, discourage any risk-taking which is inconsistent with the funds' risk profiles and fund documentation, and prevent conflicts of interest.

*Proportionate application:* UCITS managers would be given flexibility to allow for the sound application of the remuneration policies in a manner proportionate to the size, internal organisation as well as the nature, scale and complexity of the activities carried out by the manager and the fund.

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