EUROPEAN COMMISSION

MEMO

Brussels, 3 July 2012

Undertakings for collective investment in transferable securities (UCITS) – improved requirements for depositaries and fund managers – Frequently asked questions

1. What is a UCITS fund?

Investment funds are specially constituted investment vehicles, created with the sole purpose of gathering assets from investors, and investing those assets in a diversified pool of assets. By investment in investment funds, small investors can buy exposure to a professionally-managed and diversified basket of financial or other assets. Overheads are spread over the pool of investors, reducing average cost for the investor.

A UCITS fund is an investment fund regulated at European level. UCITS funds were first introduced in 1985. Since then the UCITS Directive[1] has offered European investors a wide range of high quality and safe investment products. The subsequent reforms of the Directive (2001 and 2009) have built upon the high level of investor protection and prudential supervision ensured by the Directive.

The standards introduced in the UCITS rules have also contributed to the success of the UCITS brand in third countries (notably in Asia and Latin America) where UCITS funds domiciled in the EU enjoy a significant investor base. The requirements relating to depositaries that act on behalf of undertakings for collective investment in transferable securities (UCITS) are one of the key building blocks within the UCITS framework and aim primarily to ensure a high level of investor protection.

2. What is a UCITS depositary?

A UCITS depositary is an entity that is independent from the UCITS fund and the UCITS fund's investment manager. Neither the fund manager nor any prime brokers that act as so-called 'counterparties' to a fund may also act as the fund's depositary. The independence of a depositary is necessary because the depositary essentially acts both as a supervisor (the 'legal conscience') of a UCITS fund, overseeing certain fund transactions (redemptions and investor payments to the fund) and as a custodian over the fund's assets.

[1] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L302, 17.11.2009, p 32.

In addition, a depositary retains for safekeeping the assets in which a UCITS invests and thus maintains the UCITS' and its investors' property interests. While the safekeeping of investors' assets is a core task of the depositary, the depositary also performs certain oversight functions. These functions include:

- verifying that a UCITS fund's sales, repurchase and redemption of units or shares is carried out in accordance with applicable laws,
- verifying that the net asset value of units is calculated in line with national laws and fund rules, and
- ensuring that transactions of the fund manager comply with all applicable laws and that transactions involving the fund's assets are carried out within the customary time periods.

3. Why is a depositary so important for investors?

While the fund manager makes investment decisions for the fund, the third-party depositary is in charge of holding the fund's assets in custody on behalf of investors.

The assets of the UCITS are segregated from the assets of both the depositary and the manager. Therefore, the UCITS assets are protected in case of a default by the manager or the depositary. This is a crucial pillar of investor protection in the UCITS framework.

In April 2012 total assets of UCITS amounted to almost €6 trillion, which represents a major part of the wider European investment market. Roughly 85% of the European investment fund sector's assets are managed within funds governed by the UCITS framework. Proper safekeeping of UCITS assets is therefore of great importance for UCITS investors in Europe, as well as for investors in third countries.

4. What does the proposal include?

The Commission proposal for amendments to the UCITS directive (2009/65/EC) (UCITS V) focuses on three areas, namely:

(1) clarification of the UCITS depositary's functions and improvements to provisions governing their liability, should assets be lost in custody;

(2) the introduction of rules on remuneration policies that must be applied to key members of the UCITS managerial staff; and

(3) harmonisation of the minimum administrative sanctions that are to be available to supervisors in case of key violations of the UCITS rules.

The amendments set out detailed rules on the tasks of depositaries and specify which entities can act as depositaries. These amendments broadly follow the approach on such rules for depositaries as they are already set up in the legal framework for fund managers managing investment funds dedicated to professional investors, the Alternative Investment Fund Managers (AIFM) Directive (2011/61/EU).

The amendments also clarify the tasks of depositary, including those related to financial instruments that can be held in custody such as stocks or bonds, and those related to other financial instruments such as derivative instruments.

The amendments also harmonise the depositary's oversight functions and establish conditions that govern any delegations of depositary tasks to third parties.

The proposal also better clarifies the depositary's scope of liability. In case of the loss of assets held in custody, the depositary will have to provide replacement assets to investors, without the latter having to undertake lengthy litigation to establish liability.

The amendments relating to remuneration policies require these to apply to the staff of management companies that can take decisions that have a material impact on risk profile of a fund and the management company.

The financial crisis also revealed discrepancies in the approach of supervisors to the sanctioning of breaches of UCITS rules. The Commission has proposed to introduce minimum administrative sanctioning powers that must be available to supervisors.

5. Why has Commission limited the scope of the amendments only to three main areas?

This proposal reflects lessons learned from a number of failures in the UCITS market that have led to losses of assets by UCITS investors, notably in connection with the Madoff incident. The AIFM Directive already includes safeguards that aim to mitigate the negative consequences of such failures for investors. It is necessary to extend these safeguards to retail investors as soon as possible.

With respect to other areas related to the UCITS framework, including money market funds, the use of collateral, liquidity management and the use of derivative instruments, the Commission believes more work and stakeholder consultation is needed to assess the robustness of the current framework. The Commission remains committed to taking all steps necessary to protect the UCITS brand's good reputation, and plans to consult shortly on several other aspects of the UCITS framework.

6. How will retail investors benefit from this proposal?

The proposed amendments will enhance those safeguards that are already embedded in the UCITS framework. Uniform rules on the current tasks of the depositary, on the conditions and diligence to be applied when delegating these tasks to third parties, and on the liability of depositaries have the potential to boost investment and increase confidence in the UCITS brand, especially where UCITS are sold cross-border. Currently, Member States apply different standards on depositaries which means that consumers benefit from different levels of protection depending on in which country they have invested.

Harmonising these rules will benefit retail investors by reducing uncertainty and ensuring they can continue to trust UCITS, whether marketed cross-border or not. The same holds for rules on remuneration and sanctions. Moreover, enhanced provisions on the delegation of tasks by depositaries, their due diligence, and their liability will provide for greater confidence in UCITS that invest in emerging markets in particular. This could ultimately widen the breadth of investment opportunities for retail investors.

7. What are the main differences between the provisions on depositaries in the AIFM directive and this proposal?

UCITS are open to retail investors. Therefore, a level of investor protection similar to the one contained in the AIFM Directive (which is focused on professional investors) is indispensable. In some instances, the AIFMD rules have been adapted to reflect the potential retail profile of UCITS investors. In relation to remuneration policies, the proposal reflects the approach taken with respect to AIF managers.

With regard to the types of firm that can be depositaries, the Commission has concluded that only credit institutions and regulated investment firms should be eligible to act as UCITS depositaries. These institutions provide sufficient guarantees in terms of prudential regulation, capital requirement and effective supervision. A small number of other institutions in the EU that at present are allowed to be UCITS depositaries will need to transform themselves either into credit institutions or investment firms should they wish to remain eligible to be UCITS depositaries.

With regard to the segregation of assets, the Commission has proposed to strengthen guarantees that the assets of the UCITS will always be kept separate from the assets of the depositary, in case of a default of the depositary or its sub-custodian.

Where the custody of assets has been delegated to a sub-custodian in a third country, a depositary will not be allowed to discharge its liability through a contractual arrangement -- even when such delegation is mandatory under the rules of that third country. The Commission believes that it would be inappropriate and unfeasible to require retail investors to understand the consequences of such contracts. The proposed solution should help build the trust of investors in the role of the depositary by ensuring consistency in what they can expect.

8. What are the costs and benefits?

This proposal addresses certain issues that have arisen during the financial crisis. The main purpose of the proposal is to improve protection for UCITS investors. Current differences in implementation of requirements concerning a depositary's responsibilities could undermine the reputation of UCITS as a robust legal framework suited to the needs of retail investors.

Harmonisation of the rules on the depositaries and remuneration policies across the EU will increase legal certainty for both investors in UCITS and UCITS managers and depositaries. The proposal is broadly based on the provisions on depositaries in the AIFM Directive. Consistency between UCITS and the AIFM directive should limit the costs related to the implementation of new requirements in both areas. The Commission is convinced that this proposal will contribute to the further development of the UCITS market and increased investment in UCITS by European and international investors.

9. When will UCITS V be in place?

The proposal of the Commission will now go to the European Parliament and the Council for their consideration under the codecision procedure. Once they reach agreement, Member States usually have two years to transpose the provisions into their national laws and regulations, meaning that the new rules could apply by the end of 2014. By this date, the necessary package of implementing measures should also be adopted.