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AFG RESPONSE TO THE COMMISSION'S CONSULTATION PAPER ON THE UCITS DEPOSITARY FUNCTION

The Association Française de la Gestion financière (AFG)[1] would like to thank the European Commission for publishing its consultation paper on the UCITS depositary function. AFG represents the France-based investment management industry, both for collective and discretionary individual portfolio managements, and our members include over 400 management companies. Our views are therefore strictly management companies' views and are not at all impacted by any conflict of interest with other types of participants in the value chain.

As an introduction, AFG wishes to stress the following points:

- AFG welcomes the Commission's consultation on the UCITS depositary function. The UCITS Directive dates back to 1985 and needs to be clarified.
    - Indeed, recent events have confirmed that the functions, responsibilities and oversight of depositaries differ markedly in-between European fund domiciles. This might create doubts on the soundness of UCITS regulation and results in an unlevel playing field. It is therefore important that harmonisation is at last created in this field. It is a pity, in this respect, that the studies undertaken by the Commission and by CESR have not been made public.
    - The result should not be a transfer of responsibilities from the depositary to the management company creating an unwelcome blurring of its responsibilities.

[1] AFG members are managing more than 2,400 billion euros in the field of investment management. In terms of financial management location, it makes in particular the French industry *the leader in Europe for collective investments* (with more than 1300 billion euros managed by French companies, i.e. 22% of all EU investment funds assets under management, wherever the funds are domiciled in the EU) *and the second at worldwide level*. In terms of fund domiciliation, French funds are respectively second in Europe and third at worldwide level. In terms of product interests, our association represents – besides UCITS – the employee savings schemes funds, hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

- We feel that the improvements proposed by AFG are proportionate, as they would enhance investor protection without entailing any significant costs. Indeed, it is important to take into account the potential costs that might arise form an excessive increase of depositaries'' responsibilities, such costs being ultimately borne by investors.

- The consultation is a list of questions, not a proposal for a directive. We are thankful to the Commission for involving stakeholders at an early stage in the process. As the questions are quite broad, we might take this opportunity to address issues that may not be directly tackled by the consultation.

- The activities of asset management companies on the one hand and depositaries on the other hand should be clearly defined, each entity having specific roles and responsibilities. Depositaries are specialists in the field of securities and management companies resort to them in order to take care of the securities of the UCITS they manage. We want to stress that in France, clear fire walls have been established and are fully effective in practice between asset management and depositary activities in cases where both entities belong to the same group.

- The consultation aims at updating the UCITS Directive. Therefore, our comments will mainly focus on UCITS. However, these comments on the European UCITS depositary function should be used as a basis for wider reflections on the depositary function, in particular regarding the provisions of the AIFM Directive and the agreements made between depositaries and management companies. As far as possible, the provisions on depositaries should be the same in the two Directives, except where differences are duly justified by the specific nature of the funds.

- For instance, the AIFM Directive introduces de facto a depositary passport for AIF depositaries that does not exist for UCITS depositaries yet. This differentiation is not justified and creates an unlevel playing field between the two types of funds: therefore, the passport should be established for both or for none.

Introduction - Risks borne by investors

We agree that investors might have to bear a market risk. For instance, in case of an investment in emerging markets where financial market are less developed, the settlement and recognition of propriety rights on securities can differ and consequently constitute a "market risk". However, we consider that this risk can in many cases be eliminated through the use of a CSD or a Central Counterparty (CCP) (please refer to Memo/09/314 issued on 3rd July 2009 by EEC and COM (2009) 332 final).

Another risk that investors might have to bear is the risk of "non restitution" of assets. This risk has always existed for UCITS as well as for other clients.

Question 1) Do you agree that the safe-keeping (and administration) duties of depositaries should be clarified?

Yes. It is crucial that the notion of safekeeping is clearly defined, with no ambiguity. The lack of definition in the UCITS Directive has allowed some Member States to understand the activity of safekeeping as a supervisory obligation only.

Question 2) Do you agree these duties should be clarified for each class of assets eligible to the UCITS portfolio?

For assets that cannot be kept in custody in the UCITS depositary's book, we recommend a pragmatic approach i.e. only a supervision obligation should be required which will have to be detailed in level 2 measures.

AFG suggests differentiating asset classes depending on whether they can be registered with a clearing chamber or not, as the clearing chamber must ensure itself the restitution of the relevant assets. But a broad definition should be sufficient at the level of the Directive: it would be difficult to come up with an exhaustive list of assets for which only a supervisory obligation is appropriate.

From our point of view, when speaking about "verification of the ownership of all other assets" (as stated in the AIFM Directive proposal), the depositary's responsibility should consist of obtaining confirmation that the relevant transaction took place and that relevant legal documents have been provided that the transaction has been effectively completed, as well as frequently verifying that issuer books correctly reflect the proprietary rights of the UCITS on those assets.

Incidentally, we believe that depositaries' duties should be identical for all investors which have invested in the same UCITS, whether they are retail or professional, in order to provide them with the same level of

protection and to ensure equality of treatment among them.

Question 3) Are there any other appropriate approaches?

The obligation of keeping and making restitution of the assets seems difficult to apply to all assets eligible in the portfolio of a UCITS, for instance when the depositary can not physically hold the assets. A pragmatic and reasonable approach, distinguishing asset classes depending on whether they can be registered with a clearing chamber or not (as described above), seems more appropriate.

Question 4) Do you agree to a common horizontal and functional approach of the custody duties on the listed financial instruments, to be applied to UCITS depositaries?

We agree that the same approach should be applied to all listed financial instruments.

Question 5) Is there some specificity that may be applicable to the custody functions of a UCITS depositary that should be taken into account?

We would like to prohibit any infringement of the custodian responsibility principles set in the UCITS Directive.

Question 6) Do you agree that the existing supervisory duties of the UCITS depositary should be clarified?

It should be made clear that the 5 duties described actually apply both for investment companies and common funds. The current significant differences in the two regimes of the UCITS Directive do not seem justified. In particular, the obligations regarding common funds depositaries provided by Article 22 are more numerous than the ones applicable to depositaries of investment companies as provided by Article 32.

A prior clarification of the depositaries' role is a necessary condition to the establishment of a depositary passport in the EU (as set in the AIFM Directive proposal).

Question 7) If so, what clarification do you suggest?

We would like to clarify that depositaries are in charge of the following tasks:

- Check that the fund rules are complied with;
- Check the inventory of assets in the UCITS portfolio and ensure that the valuation is calculated in accordance with the applicable rules. However, we think that depositaries do not need to perform their checks before the valuation is released: they shall perform ex post sample checks on valuations;
- Check revenues, including tax credits;
- Check ex post that transactions were performed in accordance with the relevant documentation and instruments, and in particular that the assets belong to the fund.

Question 8) To what extent does the list of supervisory duties need to be extended?

AFG believe that depositaries should be in charge of attesting the inventory of assets and reconciling the actual assets with the accounting statements. But we would like to recall as well that, according to the UCITS Directive, the valuation is part of the management services provided by management companies and as such is under the responsibility of management companies and not under the responsibility of the depositary.

Question 9) Do you agree that the 'only one depositary' requirement should be clarified?

Yes, we agree that the depositary of a UCITS must be unique so that it can have an exhaustive view of all the assets of the UCITS. In this respect, we believe that it should not be allowed to delegate the responsibility of its supervisory obligation (even though it can outsource the execution of this task to technical service providers that may for example calculate ratios on which the depositary will base its opinion). However, this should not prevent the possibility of keeping the assets elsewhere. Besides, this principle should be clarified in regard of the role and appointment of a prime broker and derivatives clearer.

Question 10) Do you think that the risks related to improper performance have been correctly identified?

Yes, we think that the risks related to improper performance have been correctly identified by the Commission.

Regarding the risk of improper performance relating to a miscalculation of the price of shares or units, we would like to remind that depositaries have an obligation of supervision which is an obligation of means, not of result. Depositaries should be responsible for making reasonability checks on valuations (including consistency checks on asset prices) after they have been issued. However, we are of the opinion that in no circumstances should depositaries impede the release of valuations.

Question 11) Do you foresee other situations where a risk associated with improper performance of the depositary duties might materialise?

We believe that a risk associated with improper performance of the depositary duties might also arise from the processing of corporate actions and tax treatment (in particular with regards to foreign securities).

Anyway, it seems difficult to make an exhaustive list of risks; however, such cases will be covered by the general provisions of the contract signed between the relevant depositary and management company.

Question 12) Do you agree that safeguards against the risk associated with the improper performance of depositary duties, such as requiring that UCITS assets be segregated from the depositary's and sub-custodian's assets, should be introduced?

Yes. Asset segregation is a fundamental requirement for security vis a vis creditors. The identification of the assets in the name of the UCITS should be a key element in order to ensure a proper protection of investors and a right of propriety on the securities held by the UCITS.

Indeed, we agree that segregating the assets of each fund at the level of sub-custodians would not be practical. However, we are of the opinion that client assets entrusted to sub-custodians should be kept in two different "pockets" (besides their own assets) distinguishing between UCITS assets and other clients' assets. Indeed, in case the depositary defaults, this would facilitate the implementation of the provisions of the Directive 1997/9/EC on Investor-Compensation Schemes and avoid the lengthy process of defining what assets can benefit from the Directive's protection.

Question 13) Do you agree there should be a general clarification of the liability regime applicable to the UCITS depositary in cases of improper performance of custody duties?

AFG calls for such a clarification that we feel being crucial. The Directive states that the depositary's liability is defined as per the national law of the UCITS home Member State. This implies that there might be differences in the regimes applying to depositaries (i.e. their obligations and the extent of their liability). Therefore, these differences should be restricted by putting the burden of proof on the depositary that would have to prove that it could not have avoided the failure to perform its obligations (including the loss of financial instruments) or the improper performance of its obligations.

The consultation (page 6) reads that "If the instruments cannot be identified and returned to their true owner, some Member States consider it legitimate for the owner of the assets (e.g. the UCITS) to be entitled to claim for immediate full compensation". We would like to highlight that the owner of the assets should be entitled to compensation "if the instruments cannot be identified or returned to their true owner". We would also like to note that the notion of compensation of assets set by the Directive is full and immediate.

However, we feel that, in case of restitution, the restitution should be defined depending on the nature of the assets: the obligation of restitution should apply to assets that are registered with a clearing chamber (please refer to question 2), in accordance with the specific rules applying to the each type of assets.

Furthermore, we believe that Article 24 of the Directive should be reworded to clarify that the liability to unit-holders may be invoked either directly by the unit-holders or indirectly through the management company. It should also be clarified that shareholders in an investment company are allowed to invoke the depositary's liability directly. Finally, the Directive implies that this legal action is regulated by national laws (for instance, company laws), which might not result in harmonised outcomes.

Question 14) What adjustments to the liability regime associated to the custody duties of the UCITS depositary would be appropriate and under what conditions?

An inversion of the burden of proof will certainly enhance investors' protection as it will oblige depositaries to have more transparency on their duties and on how they are fulfilled (for instance through the use of a sub-custodian network). Without such an inversion of the burden of proof, management companies are not able to investigate the network of providers appointed by their depositary.

Question 15) Do you agree that the conditions upon which the UCITS depositary shall be able to delegate its duties to a third party should be clarified?

Yes.

AFG is of the opinion that UCITS depositaries should remain legally responsible in all cases, be the delegation at the initiative of the depositary or the management company (in this case, the depositary can decline the delegation proposed by the management company).

We believe that the depositary should be allowed to delegate its safekeeping duties to entities authorised to exercise such an activity, provided that it remains responsible and provided that it can demonstrate that it has adequate processes applicable to the choice and monitoring of sub-custodians. Moreover, a full delegation of the depositary's safekeeping duties should be disclosed in general terms (but not specifying the names of the sub-custodians) to the management company and to the investors in the UCITS (for instance in the prospectus).

Question 16) Under which conditions should the depositary be allowed to delegate the performance of its duties to a third party?

Regarding the supervisory responsibility of UCITS depositaries, we believe that it may not be delegated and that depositaries should remain liable at all times, even though they may outsourced the execution of this task to technical service providers that may for example calculate ratios on which they will base their opinion.

Question 17) Do you agree that the depositary should be subject to additional on-going due diligence requirements when delegating the performance of its duties to a third party?

AFG believes that depositaries should be able to demonstrate that they have a documented procedure on the choice and monitoring of the sub-custodians they delegate their safe-keeping duties to or any third party they outsource the performance of their duties to.

In any case, management companies should not be under any obligation to oversee depositaries' delegated providers. In this respect, the annual certification by depositaries' independent auditors of depositaries' control processes should comfort management companies of the quality of the depositaries they work with (and the delegations they put in place).

Question 18) Do you share the Commission services approach to reviewing the ICSD, to allow UCITS to benefit from a compensation scheme where the depositary defaults?

We believe that, even though they make sense at the level of the individual investor, the amounts guaranteed by the ICDS are almost meaningless at the level of the UCITS. An efficient protection at the level of the UCITS would imply the guarantee of much larger amounts, but this would probably be too costly and too difficult to implement.

Question 19) Do you agree that UCITS holders should also benefit from compensation if their custodian defaults and these assets are lost?

This issue seems out of the scope of the UCITS Directive. However, under the ICDS, UCITS holders can already benefit from compensation if their custodian defaults and their shares are lost.

Question 20) Do you agree that the general organisation requirements that are applicable to a UCITS depositary should be clarified?

Question 21) If so, to what extent?

First of all, we believe that management companies and their depositary should be different legal entities that can however belong to the same group.

Moreover, we are of the opinion that depositaries should establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities.

Furthermore, we strongly believe that no re-use should be made by depositaries or their delegated providers without the consent of management companies.

Finally, we would like to re-assert the key importance of the principle of segregation of assets (please refer to question 12).

Question 22) Do you agree that requirements on conflicts of interest applicable to UCITS depositaries should be clarified?

Question 23) If so, to what extent?

We believe that the level 2 measures related to the management company passport and rules of conduct will have to clarify the requirements on conflicts of interest applicable to management companies. In particular, an effective separation between depositary and management company (for example through the establishment of fire walls) should prevent conflicts of interest.

Question 24) Do you agree that there is a need for clarifying the type of institutions that should be eligible to act as UCITS depositaries?

Yes.

AFG is of the opinion that only credit institutions should be eligible to act as UCITS depositaries. Indeed, only credit institutions can fulfil all the missions assigned to depositaries without resorting to delegation (for example, a UCITS may be a debtor and use credit facilities). Furthermore, we believe that this requirement would both enhance investor protection and increase harmonisation at the European level. In any case, all depositaries should be subject to similar organisational or capital requirements.

Question 25) Do you agree that only institutions subject to the CDR should be eligible to act as UCITS depositaries?

Please refer to question 24).

Besides, in our view, only management companies that hold clients' assets should have to comply with the provisions of the Capital Requirements Directive.

Question 26) If not, which types of institutions should be eligible to act as UCITS depositaries, and why?

Please refer to question 24).

Question 27) Do you agree that additional auditing requirements should be imposed, such as an annual certification of the depositary's accounts by independent auditors?

Yes.

We believe that an annual certification of the depositary's accounts by independent auditors would ensure that depositaries have adequate procedures in place to fulfil their obligations. Such a certification will in turn enhance investor protection.

Question 28) Do you agree that UCITS depositaries should be subject to a specific 'depositary' approval by national regulators?

Yes.

Indeed, the depositary function is specific compared to the mere account provider function.

Furthermore, such a requirement is a necessary condition prior to the establishment of a depositary passport (the approval by national regulators will also have to be recognised by other Member States).

Question 29) Do you believe that there is need to promote further harmonisation of the supervision and cooperation by European regulators of depositary activities? What are your views on the creation of an EU passport for UCITS depositaries?

Yes, in particular all European regulators should have an injunction power towards depositaries established in their jurisdiction.

AFG supports the establishment of a depositary passport. However, we agree that there is a need to first harmonise the supervision and cooperation by European regulators of depositary activities. In particular, we believe that the responsibilities and the supervisory function of the depositary should be fully harmonised.

Question 30) As far as the UCITS portfolio and UCITS units or shares are concerned, do you agree that their value should be assessed by an independent valuator?

AFG strongly believes that management companies should remain responsible for the valuation of the UCITS portfolio and UCITS units or shares. Indeed, in many instances, the establishment of the value of the assets in the UCITS portfolio relies on the knowledge of management companies. Also, involving an additional entity in the valuation process will make it more complex and will entail significant costs that will undoubtedly be borne directly or indirectly by final investors.

In this view, management companies should have the required resources or implement the appropriate monitoring of the delegated technical service providers. A proper valuation should be ensured through:

- Adequate internal organisational rules;
- The supervision by depositaries that ensure that the valuation function is independent from the investment and risk management functions (internal organisational rules, Chinese walls…) and has adequate resources;
- The regular control by auditors.

Question 31) If so, what should be the applicable conditions for an entity to be eligible to act as an UCITS Valuator?

AFG is opposed to the concept of mandatory independent valuator. Please refer to question 30).

If you wish to discuss the contents of this letter with us, please contact myself at +33 1 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), or Stéphane JANIN, Head of International Affairs Division at +33 1 44 94 94 04 (e-mail: s.janin@afg.asso.fr).

Sincerely,

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