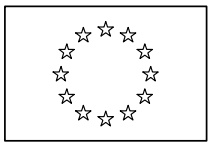

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WORKING DOCUMENT OF THE COMMISSION SERVICES (DG INTERNAL MARKET AND SERVICES)

CONSULTATION PAPER ON THE UCITS DEPOSITARY FUNCTION AND ON THE UCITS MANAGERS' REMUNERATION

Important comment: this document is a working document of the Internal Market and Services Directorate General of the European Commission for discussion and consultation purposes. It does not purport to represent or pre-judge the formal proposal of the Commission.

INTRODUCTION

The Commission intends to present next year a new legislative proposal to update the framework applicable to UCITS depositaries and to introduce new provisions on the remuneration of UCITS managers.

The requirements relating to UCITS depositaries are an important building block within the UCITS framework so as to ensure a high level of investor protection. The depositary is an entity independent from the fund manager to whom the assets of a UCITS fund are entrusted. The depositary also performs certain oversight functions. The losses suffered by UCITS holders after the Madoff fraud and the Lehman Brothers default revealed divergences in interpretations of these functions, which raised a number of questions as to whether the UCITS framework in this area needed to be further harmonised and strengthened, so as to ensure a level playing field in terms of UCITS investor protection measures across all Member States.

Therefore, the Commission launched in 2009 a first public consultation in order to strengthen the regulation and supervision of UCITS depositaries. A feedback statement[1] published in 2009 showed that the clarification of the UCITS depositary function was an essential step for a comprehensive review of the existing European regulatory principles applicable to depositary functions.

The same year, the Commission published a proposal in order to regulate the alternative funds managers which also introduced some provisions application to the depositary function in order to provide a better and more transparent regulation of the entity holding the fund's assets and to offer an appropriate level of investor protection.

In this context, the Commission committed[2], to introduce targeted changes to the depositary provisions in the UCITS Directive[3]. This changes aim at: (i) clarify better the UCITS depositary function[4] and (ii) ensure consistency between the legislation applicable to the depositaries of UCITS and that applicable to the depositaries of alternative investment funds[5], with a view also to improving the levels of investor protection afforded.[6]

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1 http://ec.europa.eu/internal_market/consultations/2009/ucits_depositary_function_en.htm

2 In its communication of 2nd June , available at : 2010http://ec.europa.eu/internal_market/finances/docs/general/com2010_en.pdf

3 Directive: 2009/65/EC.· OJ L 302, 17.11.2009, p. 32-96 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF

4 In a public consultation launched by the European Commission in July 2009, the vast majority of stakeholders indeed confirmed the need to clarify and better harmonise the UCITS depositary function at the level of the Community. http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm

5 This consultation is referring to the text of the AIFM Directive as approved by the European parliament on the 11th November 2011

6 The UCITS depositary functions will to be technically coordinated with the regime applicable to the alternative funds' depositaries.

The financial crisis also revealed that the remuneration and incentive schemes commonly applied within financial institutions were themselves exacerbating the impact and scale of the crisis. Remuneration policies contributed to short-termism and incentivised excessive risk taking, thereby increasing levels of systemic risk. In the light of these systemic issues and commitments that were made at the G20 level to address them, the EU is taking coordinated steps across all financial services sectors to introduce consistent requirements governing remuneration policies, as set out in the Commission Recommendation of April 2009.[7] The adoption of CRD III,[8] the Directive on Alternative Investment Fund Managers (AIFM Directive)[9], and the ongoing work on the level 2 measures under Solvency II will confirm the determination of the EU to fulfil these commitments. Extending this work to also cover the managers of UCITS is a natural additional step in this process.

The purpose of this document is to collect further views, and evidence to support them, on the key options that are emerging in these two areas .A feedback is sought on the impact of the proposed changes on the UCITS industry and its stakeholders, in order to identify the best technical options. The issues involved are wide-ranging. They will have implications for investors, depositaries, auditors, asset managers and regulators alike and the conclusions from this consultation will serve as a basis for the Commission to review the UCITS Directive in 2011.

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There a number of other Commission initiatives that may have an impact on this work:

- ***Commission Communication for reinforcing sanctioning regimes in the financial sector***

The financial crisis has put into doubt whether financial market rules are always respected and applied as they should be across the Union. Ensuring proper application of EU rules is the task of national authorities, who need to act in a coordinated and integrated way. Efficient and sufficiently convergent sanctioning regimes are the necessary corollary to the new European Supervisory Authorities which will be set up on 1 January 2011, to also bring improvements in the coordination of national authorities' enforcement activities. On the 8th December 2011, the Commission has issued a consultation that sets out possible EU actions for achieving greater convergence in and reinforcement of national sanctioning regimes in the financial services sector. All stakeholders are strongly invited to express their views and opinions on this important

[7] http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf

[8] Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisation, and the supervisory review of remuneration policies (CRD III).

[9] The AIFM Directive was formally approved by the European Parliament on 11 November 2010. Its publication in the Official Journal, following its formal adoption by the Council and the European Parliament, is expected for the first quarter of 2011. http://register.consilium.europa.eu/pdf/en/10/st14/st14602.en10.pdf

Communication, and to consider in particular how the principles examined in the Communication might apply in the UCITS environment.

- ***Commission Communication on corporate governance in financial institutions***

The financial crisis revealed significant weaknesses in corporate governance in financial institutions: board supervision and control of management was insufficient; risk management was weak; inadequate remuneration structures for both directors and traders led to excessive risk-taking and short-termism; and shareholders did not exercise control over risk-taking in the financial institutions they owned. These weaknesses played a role in the crisis and timely and effective checks and balances in governance systems would help prevent any future crisis.

On the 2nd June 2010, the Commission issued a Green Paper, launching a public consultation on possible ways for improving corporate governance in financial institutions and remuneration policies. The Commission is committed to ensuring that the interests of consumers and other stakeholders are better taken into account, businesses are managed in a more sustainable way and bankruptcy risks are reduced in the longer term. Therefore, the conclusions of the consultation may also be taken into consideration in the framework of the corporate governance requirements for UCITS.

- ***Proposal for the review of the Investor Compensation Schemes Directive***

The Investor Compensation Schemes Directive (ICSD, 1997/9/EC)[10] aims to protect investors against the risk of losses in the event of an investment firm's inability to repay money or return assets held on behalf of its clients. Under the ICSD, national compensation schemes are only required to cover investment firm providing investment services (as defined under the Markets in Financial Instruments Directive – (MiFID))[11] . A proposal to review the existing EU legislation has in respect of the above mentioned matters been recently published. It foresees the inclusion of UCITS under the scope of the ICSD, in order to protect UCITS holders in the case that the value of the UCITS units or shares has been affected due to the failure of a UCITS depository or sub custodian to return the financial instruments held in custody.[12] The ICSD proposal is a last resort and a limited tool and does not interfere with the UCITS depositary liability regime which applies where assets are lost[13] . It only aims at creating a level playing field between the protection available to MiFID investors and UCITS holders. Investors can invest in the same type of financial instruments either directly or through a fund and should therefore benefit from the same level of guaranty where assets 'physically' disappear.

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[10] http://ec.europa.eu/internal_market/securities/isd/investor_en.htm

[11] http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

[12] The protection granted under the ICSD benefits essentially retail investors.

[13] It excludes all investment losses.

UCITS holders should therefore also be able to claim compensation from such a scheme for damage caused by the loss of the (UCITS) assets by a UCITS depository or a sub custodian. In order to achieve this, the Commission has proposed that UCITS holders should be able to claim compensation from compensation schemes where UCITS assets have been lost and where this damage cannot be mitigated because the depositary or its sub custodian has defaulted. This would be a last resort tool, independent from the rules concerning the depositary liability regime in the ordinary course of business. Compensation would be limited to 50.000 EUR.

- ***Directive on legal certainty of securities holding and transactions ('SLD')***

Building on the conclusions of the 2001 and 2003 Giovannini Reports and the Legal Certainty Group in 2008, the Commission is now preparing a draft *Directive on legal certainty of securities holding and transactions*[14] (Securities Law Directive – SLD). The legislative proposal concerns the ownership of securities. It is expected to address the legal aspects of holding and disposition of assets as well as the activity of safekeeping and administration. The Commission will seek to coordinate its work on UCITS depositaries with this work on the legal certainty of securities holding and transactions, since a depositary may act as a security account provider, thereby raising similar technical issues; however specificities may arise in relation to custody functions in the case of UCITS that need to be taken account of.

- ***Legislation on Central Securities Depositories***

The European Commission has announced legislation on Central Securities Depositories ("CSDs") for the first half of 2011. The Commission services are working on a legislative proposal that aims to establish a common prudential framework that ensures safety and soundness of CSDs and to create an enhanced framework for cross-border settlement activity in the European Union. The Commission services will work to delineate the scope of application of the respective legislative instruments.

- ***AIFM Directive***

The objective of the Directive on Alternative Investment Fund Managers (AIFM Directive) is to create a comprehensive and effective regulatory and supervisory framework for AIFM at the Community level. This directive covers investment products that are mainly structured for professional investors. It includes some detailed provisions relating to the function of depositaries, for example on safekeeping and supervisory functions. It also contains principles of sound remuneration policy for managers of AIFs in line with the Commission Recommendation of April 2009 and CRD III.

With regard to the rules on depositary functions the AIFM Directive imposes new eligibility conditions upon institutions willing to act as AIF depositaries. It proposes to strengthen the depositary liability regime with an inversion of the burden of proof, and clarifies the conditions under which a depositary may delegate safe-keeping of entrusted

[14] http://ec.europa.eu/internal_market/consultations/2010/securities_en.htm

assets to another entity. These rules aim to provide a better and more transparent regulation of the entity holding the fund's assets and to offer an appropriate level of investor protection. The same level of investor protection as offered by the AIFM Directive proposal should be at the minimum extended to UCITS funds. To that end, the Commission is seeking to coordinate its work on UCITS depositaries with the provisions relating to the depositary function in the AIFM Directive. The requirements on the function of the depositary in the UCITS framework shall be made consistent with those for the depositary of an AIF be to extent that both the AIF and UCITS operate under similar technical constraints; taking into consideration specificities linked to the UCITS investment environment.

As to rules on remuneration policies, it has been broadly recognised that poorly designed remuneration structures can have a detrimental effect on the management of risk and induce excessive risk-taking behaviour by certain categories of staff of AIF managers. It has been therefore decided to introduce into the AIFM Directive principles on remuneration policies promoting sound and effective risk management and do not encouraging risk taking inconsistent with the risk profiles of the managed AIF[15]. As in the case of rules on depositaries, the Commission services will seek consistency with the AIFM Directive rules on the remuneration policy when elaborating on the proposal for UCITS managers, whilst at the same time taking due account of the specificities of the UCITS area.

- ***The PRIPs workstream and its relationship with the potential amendments addressed in this consultation***

The Commission announced in its April 30th 2009 Communication on Packaged Retail Investment Products (PRIPs) that legislative changes were necessary at the European level to improve consumer protection standards, and address a collapse in confidence following the financial crisis. PRIPs represent the core of the retail market for investment products, encompassing structured products, insurance investment products and investment funds including UCITS. The Commission has committed to taking steps at the European level to achieve greater convergence and higher standards in rules, adopting a 'horizontal' perspective.

All relevant details on the PRIPs work are subject to a separate consultation published on 26th November 2010[16]. That PRIPs consultation addresses the possibility of certain targeted changes to the UCITS framework, which will not be discussed in the present consultation. These changes are primarily related to direct sales of UCITS by UCITS management companies, and ensuring these are regulated in a manner which is consistent with the rules on other direct sales by other kinds of product provider. Following the given benchmark for PRIPs, broad MiFID principles would be applied to any conflicts of interest in relation to the selling activity of the management company, including in regards the remuneration of the management company acting as a seller of UCITS. In relation to disclosures, while the KII for UCITS is the benchmark for all other PRIPs and material changes to that benchmark are not expected, it cannot be entirely ruled out that

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15 See Annex to this consultation paper.

16 http://ec.europa.eu/internal_market/consultations/2010/prips_en.htm

improving comparability between PRIPs might require some small adjustments to the benchmark itself. However, the Commission services are aware that firms and supervisors are currently working to implement the KII, and the Commission services recognize that it is not proportionate to make adjustments to the KII whilst it is being implemented. On this basis, the Commission services intend only to address any emerging adjustments that might be necessary once the KII has been implemented and bedded down, such as may be rolled into the normal cycle of ongoing review and revision work.

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1. UCITS DEPOSITARIES

The European depositary industry is today entrusted with safe keeping of around €5.6 trillion worth of UCITS assets.[17] Since the adoption of the UCITS Directive in 1985, the rules relating to depositaries in the Directive have remained mostly unchanged: there are a number of generic principles applying to depositaries, leaving room for diverging interpretations of their duties and related liabilities. As a result, different approaches have developed across the European Union, leading to UCITS investors being provided with different levels of protection in different jurisdictions. The potential consequences of these divergences particularly emerged in the course of the financial crisis[18] and the Madoff fraud. In the light of this, the Commission is exploring proposals for ensuring there is effective investor protection across the whole UCITS depositary sector.

The Commission is also seeking to coordinate its work on UCITS depositaries with the provisions relating to the depositary function in the AIFM Directive, as adopted by the European Parliament last 11th November[19]. The requirements on the function of the depositary in the UCITS framework will be made consistent with those for the depositary of an AIF to extent that they show operational similarities.[20] However, the review of the liability regime applicable to the UCITS depositary will take into consideration specificities linked to the UCITS investment environment and its suitability for retail investors.

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[17] At the end June 2010, the number of UCITS reached 36,110. Source: EFAMA Statistical Release №42. It covers all finacial assets that are eligible to a UCITS portfolio, including equities, bonds, units of UCITS but also, listed and OTC derivatives.

[18] One of the consequences of the financial crisis was the bankruptcy of the Lehman Brothers International Europe, the Lehman UK entity which collapsed in 2008. This entity was entrusted as a sub-custodian with assets of some collective investment schemes (although non-UCITS funds, the regulatory model was similar to that of UCITS in terms of depositary rules).

[19] http://register.consilium.europa.eu/pdf/en/10/st14/st14602.en10.pdf

[20] There is a need to make these clarifications consistent when dealing with depositaries across the EU regulatory framework. There are indeed some strong similarities for both UCITS and non-UCITS depositary safe keeping function as they will often face similar technical constraints when they safe-keep assets of a similar nature (e.g. derivative contracts, securities, etc.).

A. Depositary's duties

1.Safe-keeping

The UCITS Directive currently provides that all assets of the UCITS fund must be entrusted to a depositary for safekeeping. However the Directive does not define what safekeeping is or what exact duties are covered by the notion of "safe-keeping". CESR mapping[21] exercise which was held after the Madoff fraud and the Lehman default in order to identify the current "state of play" of the rules applicable to the UCITS depositaries across Europe, revealed that the safekeeping principle has been understood in different ways across Europe. The Madoff fraud and the Lehman default have demonstrated that these differences and inconsistencies have created legal and technical uncertainties that may be detrimental to UCITS holders and the Single Market.

The fragmentation of the regulatory framework applying to safekeeping has also become more pronounced due to an increased diversification and internationalisation of UCITS investment portfolios. Changes to the UCITS directive introduced in 2001 extended the scope of eligible assets for UCITS to new classes of assets.[22] As a result, UCITS managers now invest in a much greater number of countries and in more complex instruments than in 1985.

Box 1

It is necessary to define what activities and responsibilities are related to the notion of "safe-keeping" of assets.

The Commission services are aware that in practice the safekeeping tasks of the depositary differ depending on the legal characteristics of the financial instruments, which are generally differentiated between two main basic categories.[23] The first category is financial instruments that can be registered in a security-account by the UCITS depositary (e.g. equity, bonds, etc.), and the second is eligible financial instruments and assets that may only be followed through a position-keeping book (e.g. derivative contracts).[24] Detailed EU requirements do not yet exist concerning the safekeeping of a security held in an account, or the safekeeping of derivative contracts, leading to inconsistencies in the approaches taken across different Member States. This issue has been taken into account in the provisions applicable to Alternative investment

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[21] http://www.cesr.eu/index.php?docid=6064.

[22] Including money market instruments, index-based funds including exchange traded funds (ETFs) fund of funds, derivatives (options, swaps, futures/forwards) or other over-the-counter derivatives. Please refer to Directive 2007/16/EC, available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:079:0011:0019:EN:PDF

[23] Please refer to the Consultation feedback document, page 10: http://ec.europa.eu/internal_market/consultations/docs/2009/ucits/feedback_statement_en.pdf

[24] Please refer to CESR's response to the 2009 consultation on the UCITS depositary function. http://www.cesr.eu/index.php?docid=6064.

funds' depositaries in the AIFM Directive[25]. This specifically differentiates safekeeping duties between (i) those relating to custody of financial instruments kept in the name of the fund on the depositary's book and (ii) the monitoring of other assets that cannot be kept in custody by the depositary.

Box 2

It is envisaged to complete articles 22 and 32 of the UCITS Directive,[26] in a way which is consistent with the approach in the AIFM Directive, in order to:

- Distinguish safekeeping duties between (1) custody duties relating to financial instruments (such as securities) that can be held in custody by the depositary and (2) asset monitoring duties relating to the remaining types of assets. A reference to the custody of physical assets, such as real estate or commodities, is not necessary because such assets are currently not eligible for holding within a UCITS portfolio;[27]

- Supplement the requirements on custody duties with a segregation requirement, so that any financial instruments on the depositary's book held for a UCITS can be distinguished from the depositary's own assets and at all times be identified as belonging to that UCITS; such a requirement would confer an additional layer of protection for investors should the depositary default;

- Equip the depositary with a view over all the assets of the UCITS, cash included.[28] The directive should more explicitly make clear that no cash account associated with the funds' transactions can be opened outside of the depositary's acknowledgement, with a view to avoiding the possibility of fraudulent cash transfers;

- Introduce new implementing measures in the mentioned Articles defining detailed conditions for performing depositary monitoring and custody functions, including (i) the type of financial instruments that shall be included in the scope of the depositary's custody duties; (ii) the conditions under which the depositary may exercise its custody duties over financial instruments registered with a central security depositary; and (iii) the conditions under which the depositary shall monitor financial instruments issued in a nominative form and registered with an issuer or a registrar.

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25 http://register.consilium.europa.eu/pdf/en/10/st14/st14602.en10.pdf

26 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF

27 Please refer to the UCITS Directive n° 2009/65/ CE
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:FR:PDF
and the 'Eligible Assets Directive" n°2007/16/CE
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32007L0016:FR:NOT

28 http://register.consilium.europa.eu/pdf/en/10/st14/st14602.en10.pdf

2. Oversight functions

The oversight duties listed in articles 22 and 32 of the UCITS Directive vary according to the legal form of the UCITS. For a UCITS with a corporate form (an investment company), the depositary must only ensure that:

- The sale, issue, re-purchase, redemption and cancellation of shares are carried out in accordance with the law and with the investment company's instruments of incorporation;

- In transactions involving the investment company's assets, any consideration is remitted to it within the usual time limits; and

- The investment company's income is applied in accordance with the law and its instruments of incorporation.

By contrast, the depositary of a UCITS with the form of a unit trust must in addition ensure that:

- The value of units is calculated in accordance with the applicable national law and the fund rules; and

- The instructions of the management company are carried out, unless they conflict with the applicable national law, the fund rules or its instruments of incorporation.

In spite of these differences, respondents to the 2009 consultation highlighted that most UCITS depositaries have implemented oversight processes in a similar way for both the company and unit trust legal forms. In addition, the AIFM Directive refers to a harmonised list of five oversight functions that the AIF Depositary has always to perform, independently from the various legal forms that alternative funds may have.

Box 3

It is envisaged to achieve a higher degree of consistency in the oversight duties to be performed by UCITS depositaries: the oversight duties related to UCITS with a corporate form should be aligned with those to be performed in respect to UCITS with a common fund form (article 22).

The UCITS Directive already includes a precise list of oversight duties to be performed by a UCITS depositary.[29] However, evidence shows that national regulators have interpreted these duties in different ways and have prescribed different types and levels of controls; the recent CESR regulatory mapping exercise of January 2010 confirmed inconsistent approaches to oversight duties across Member States.[30] This lack of a

[29] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF

[30] Please refer to CESR mapping exercise available at: http://www.cesr.eu/index.php?docid=6473. For instance, in some Member States these duties cover the verification that the investment decisions made by the management company are in compliance with the fund regulation and the fund prospectus, whilst in others supervisory duties of depositaries merely consist of checking the investment limits applicable to the fund following the execution and reporting of trades[17]. National differences emerge also as regards control of the calculation of net asset value (NAV), the role of the

harmonised approach to the depositary's supervisory duties may lead to inconsistencies in levels of protection for UCITS investor. This could be addressed through a higher degree of harmonisation of the detailed technical and operational constraints that should apply to the UCITS depositary when performing its supervisory duties.

Box 4

It is envisaged to introduce implementing measures that will clarify further the scope of each listed supervisory duty, for example the methodology to be used for the calculation of the Net Asset Value of the UCITS.

3. Delegation of the depositary's tasks

Currently there are cases where UCITS depositaries delegate certain of their functions, such as the custody of securities, notably where UCITS invest in securities issued outside the EU. In some countries, equities must be held by a local custodian or by an entity affiliated to a local Central Security Depositary. As no UCITS depositary institution can ensure a worldwide physical presence (in host Member States or in third countries), safe-keeping in these cases is delegated to a network of sub custodians.

The UCITS Directive does not currently elaborate on the conditions applicable to the delegation of depositary activities by the depositary. CESR's submission to the Commission consultation in 2009 and the CESR mapping exercise published in 2010 both highlight a variety of regulatory standpoints amongst Member States.[31] Some Member States restrict the use of delegation to certain depositary duties only, while others impose various conditions that need to be met before depositary duties can be delegated.

The Madoff and the Lehman cases revealed that the risks associated with the use of local sub-custody networks are not negligible, if a third party fails to perform its duties appropriately or simply defaults. These concerns have been taken into account in the AIFM directive, which provides that the depositary may not delegate to third parties any of its functions other than safekeeping duties and includes specific conditions that must be fulfilled. Similar safeguards on delegation might also be introduced for UCITS, so as to improve the level of investor protection when assets are held by sub custodians.

Box 5

It is envisaged to restrict more explicitly the delegation of the depositary task to the safekeeping duties and that the conditions and requirements upon which a UCITS

depositary in relation to the subscription and redemption process, or the fact that controls should be made *"Ex Post"*.

[31] Please refer to CESR's response to the 2009 consultation on the UCITS depositary function. http://www.cesr.eu/index.php?docid=6064. Please also refer to CESR mapping available at: http://www.cesr.eu/index.php?docid=6473.

depositary may entrust its safekeeping duties to a third party should be aligned with those under the AIFM Directive.[32]

It is also envisaged to require additional information for UCITS investors be published (for example in the prospectus) where a network of sub-custodians is to be used. Such information would specify the risk that such a sub-depositary network might fail or default, and how this risk can be dealt with.

Finally, implementing measures are envisaged in order to detail the depositary's initial and on going due diligence duties, including those that apply to the selection and appointment of a sub-custodian.

B. UCITS depositary liability regime

The liability regime applying to UCITS depositaries will have a number of elements, depending on the specific duties and obligations in question. Again, the 2010 CESR mapping exercise revealed that Member States have diverging approaches.

1. Improper performance

In relation to the duties of the depositary in general (not only those directly related to safekeeping of assets), a distinction might be drawn between 'unjustifiable' failures to perform duties, and the possibility of circumstances in which a failure to perform might be justifiable. The 2010 CESR mapping exercise revealed that Member States' have differed in their interpretation on this point. This issue has been addressed in the AIFM Directive, which identifies the possibility of a negligent or intentional failure of a depositary to properly perform its obligations pursuant to the Directive.

Box 6

It is envisaged that the depositary liability regime might be clarified in case of a UCITS suffering losses as a result of a depositary's negligence or intentional failure to perform its duties.

2. UCITS depositary specific liability in case of loss of assets

The possibility of a failure in safekeeping leading to the loss of assets raises the question as to who should be liable for any loss of assets entrusted to the UCITS depositary. In general terms, the AIFM Directive has taken specific steps to set out the depositary's obligations where assets are lost, so as to create an overall obligation on the depositary to return financial instruments of an identical type or the corresponding amount of the lost financial instruments to the AIF or, as the case may be, to the AIFM acting on behalf of the AIF, without undue delay.[33]

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[32] http://register.consilium.europa.eu/pdf/en/10/st14/st14602.en10.pdf

[33] http://register.consilium.europa.eu/pdf/en/10/st14/st14602.en10.pdf

It is clear that the level of protection for UCITS should not go below the standard applied for the AIF and that the large retail based of UCITS investors should be provided with the necessary guaranty for them to place their confidence in UCITS.

Box 7

It is envisaged to clarify the UCITS depositary liability regime in case of loss of assets. Accordingly, the UCITS depositary shall be under the obligation to return the financial instruments of the identical type or of the corresponding amount to the UCITS. No further discharge of liability in case of loss of assets is envisaged, except in case of force majeure. Implementing measures should be introduced, as necessary, to clarify all necessary underlying technical aspects, for example to identify the circumstances under which assets may be lost.

3. The scope of the UCITS depositary liability when assets are lost by a sub custodian

The articles 22 and 32 of the UCITS Directive state that the "depositary's liability as referred to in Article 24 and 34 accordingly 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".[34] Therefore, where a sub custodian has lost assets, the depositary has the same *prima facie* responsibility as it would be the case if the failure was its own. This provision is essential for maintaining investor's confidence when investing in UCITS.

Articles 22 and 32 have remained unchanged since 1985. However, the UCITS investment environment has evolved. UCITS are now able to invest in a wider range of financial assets, which may be more complex and also may be registered outside the EU (for instance, in emerging markets); fund portfolios are increasingly diverse and international. As a consequence, holding and transferring assets through sub-custody arrangements, so as to match the needs of the fund's management, have become increasingly common.[35] Recently, however, the Madoff fraud and the Lehman default have shown that the risks associated with the use of local sub-custody networks are not negligible. Assets can be lost at the level of the sub-custodian, which might include loss through the negligence of the sub-custodian or the bankruptcy of the sub-custodian, thereby exposing the depository to liabilities.

However, the *prima facie* depositary liability regime in such cases is not dealt with in the same way across Member States: some apply a so-called 'strict' liability regime, where the depositary has an immediate obligation to return the lost asset to the UCITS,[36] while others

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[34] Please refer to CESR mapping available at: http://www.cesr.eu/index.php?docid=6473. Please also refer to CESR's response to the 2009 consultation on the UCITS depositary function. http://www.cesr.eu/index.php?docid=6064.

[35] Please also refer to Directive 2007/16/CE, available at
http://eur lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:079:0011:0019:EN:PDF
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32007L0016:FR:NOT

[36] This is so-called 'Obligation de résultat'.

take the view that the loss of assets does not necessary imply a failure to perform on the part of the depositary which is 'unjustifiable'.[37]

All these elements have been taken into account in the context of the negotiations on the AIFM Directive, which proposes to introduce a general principle of liability, but which also limits this through certain exemptions. This UCITS review offers a means for reaching an equivalent degree of clarity in the UCITS legislative environment and a similar legislative structure could be adopted.

Nevertheless, given the very large investors base and the retail nature of UCITS holders, introducing a regime with the same contractual possibility for the depositary to be discharged of its liability as it may be the case in the AIFM Directive, is not considered to be entirely appropriate, or proportionate. To a similar extent, envisaging that the liability of the depositary could be discharged where assets are transferred to a sub-custodian that does not comply with delegation criteria would also not be appropriate, In fact, in a UCITS environment such transfer of assets to a sub custodian which does not fulfil the delegation criteria should not be permitted in the first place.

Another example relates to the potential systemic risk as a consequence of the "immediate" obligation to return the assets to the fund if they are lost by a sub-custodian. In jurisdictions where UCITS depositaries face an immediate obligation to return 'lost' assets to the fund as a result of a sub custodian's bankruptcy, depositaries will often mitigate the UCITS losses before recovering assets as may be possible following the insolvency proceedings.[38] In the feedback provided to the 2009 Commission consultation, the obligation for an "immediate" return of the assets by the depositary was identified by the industry as a source of systemic risk[39]. However, it is very difficult to assess, based on documented evidence and detailed data, what exact proportion of UCITS assets that are safekept through a sub-custodian network and to measure what liability UCITS depositary may face as a consequences of an immediate obligation to return the assets to the fund, should they be lost by a sub-custodian.

Box 8

As already provided under art. 22 and art. 32 of the UCITS directive, it is envisaged to maintain the rule according to which the depositary's liability is not affected if it has entrusted to a third party al or some of its safekeeping tasks. As a result, the depositary faces the same level of liability, should the UCITS assets be lost by a sub-custodian. Moreover, it is envisaged that the legislative proposal should clarify the fact that if assets are lost, the UCITS depositary liability regime has the general obligation to return the financial instruments of the identical type or of the corresponding amount to the UCITS with no delay.

As mentioned above, no further discharge of liability (either regulatory or contractual) in case of loss of assets by a sub custodian shall be envisaged, except in case of "force

[37] Please refer to CESR mapping available at http://www.cesr.eu/index.php?docid=6473

[38] Although assets have been duly segregated, bankruptcy proceedings may be long and not result in assets being returned to the sub-custodian creditors before long.

[39] http://ec.europa.eu/internal_market/consultations/docs/2009/ucits/feedback_statement_en.pdf

majeure".

4. Burden of the Proof

The AIFM directive proposes to strengthen the depositary liability regime with an inversion of the burden of proof. This is to lead to better and more transparent compliance with all obligations by the entity holding the fund's assets, and to a general rise in the level of investor protection. In the Commission' services view, the level of protection offered by the AIFM Directive should be extended to UCITS funds, as it is evidently not appropriate to have a less stringent approach for investors in UCITS than for those in AIF.

Box 9

It is envisaged to clarify that the depositary should carry the burden of demonstrating that it has duly performed its duties.

5. Rights of UCITS holders action against the UCITS depositary

Another important issue concerns the "direct" or "indirect" rights of those who invest in UCITS to raise claims relating to the liabilities of depositaries. The UCITS Directive currently provides different regimes for UCITS investors depending on the legal form of the UCITS. Article 24 of the Directive currently states: "*Liability to unit-holders may be invoked 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."*

This article has remained unchanged since 1985 and no similar provision exists for UCITS share-holders. However, it is viewed that UCITS units-holders and UCITS share-holders should have the same rights regardless the legal structure of the UCITS they invest in. This approach has already been adopted under the AIFM directive, where investors in the fund have the right to claim in relation to the liabilities of depositaries either directly or indirectly through the management company, irrespective of the legal from of the fund.

Box 10

It is suggested to align the rights of UCITS investors, so that both share- and unit-holders are able to invoke claims relating to the liabilities of 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 unit-holders.

Finally, implementing measures should also be introduced in order to encourage a high degree of harmonisation, for example to detail the conditions and procedures under which shareholders may directly use their rights towards a UCITS depositary.

C. Eligibility criteria

1. Eligibility criteria

The eligibility criteria referred to in the UCITS Directive permit Member States to set out the types of entities which can be UCITS depositaries at the national level. This has led to divergent approaches across Member States: out of the 17 Member States that require depositaries to be credit institutions, 12 impose specific capital requirements just for carrying out custody activities or other related UCITS depositary functions.[40] These divergences also translate into different levels for the capital requirements applied to institutions capable of acting as depositaries, which can range from €5 to 100 million. In those Member States that allow entities other than credit institutions to act as a UCITS depositary, only 3 require depositaries to fulfil additional capital requirements. These divergences in the level of capital required in order to perform UCITS depositary duties may impact the level of robustness of these entities, should they be liable to mitigate a UCITS loss. Given that UCITS depositaries represent a heterogeneous population, and that a considerable number of UCITS funds are sold on a cross-border basis, this situation may create uneven levels of investor protection where claims are made against liable depositaries.

The Commission services believe that a list of eligible entities in the UCITS Directive itself would give more clarity and certainty for investors, who would be able to identify more precisely the group of relevant institutions that would offer all the necessary operational and asset guarantees so as to be capable of effectively fulfilling UCITS depositary functions. A similar approach is already envisaged under the AIFM Directive.[41]

Box 11

It is suggested to introduce an exhaustive list of entities that should be eligible to act as UCITS depositories, aligned with the AIFM Directive list. Such a list should include: credit institutions, authorised 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).

2. Location of the depositary (passport issues)

The ongoing work relating to the clarification of the UCITS depositary framework targets a higher degree of harmonisation of the depositary function across Europe. It also provides an opportunity for opening discussions with respect to the concept of a

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[40] Please refer to CESR mapping available at: http://www.cesr.eu/index.php?docid=6473: "*The annex 1-part 2 of the CRD imposes additional capital requirements (15%) for CRD Firms when they provide an agency service of safekeeping, including custodianship of financial instruments (which service should be consider as part of the operational risk incurred by the CRD firm). "Under the Standardised Approach, the capital requirement for operational risk is the average over three years of the risk-weighted relevant indicators calculated each year across the business lines referred to in Table 2*."

[41] http://register.consilium.europa.eu/pdf/en/10/st14/st14602.en10.pdf

UCITS depositary passport. The Commission services have focused the ongoing review on improving the current legislative framework, as a direct and timely response to vulnerabilities revealed by the financial crisis. Introducing regulatory approval for depositaries or depositary EU passport provisions could result in further delay to this response, so these elements have not been included. This focus was also largely supported in the first consultation on the depositary function, where respondents indicated that while a UCITS depositary passport may be a good initiative for the near future, more extensive consultation was needed, and steps should be taken first to clarify and better harmonise the substantive content of the UCITS depositary framework.[42]

Box 12

It is envisaged that a provision is introduced into the UCITS Directive creating a commitment to assess and re-examine the need to address depositary passport issues, to be undertaken a few years after the new UCITS depositary framework has come into force.

D. Supervision issues

1. Supervision by national regulators

The Madoff and the Lehman cases have demonstrated that claims by UCITS investors for compensation have been handled in different ways across Europe, depending on the legal nature of a depositary's duties and the role of the national supervisor. In some Member States, the rules regarding a UCITS depositary's duties and liabilities are adopted and enforced by national supervisory authorities as administrative rules. In these cases the national supervisor is competent for sanctioning the depositary and for deciding upon investors' indemnification, although such decisions may be challenged in a civil court.[43] Other Member States have a different approach. Their national supervisor may only have competences to sanction a depositary where it has disrespected organisational rules, whereas liability issues arising towards investors in the case of loss assets must be directly raised in a civil court.[44] Depending on the administrative or civil law nature of the rules, the power to sanction depositories rests within or outside the scope of the direct competence of the national supervisors.

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[42] http://ec.europa.eu/internal_market/consultations/docs/2009/ucits/feedback_statement_en.pdf

[43] For the AMF ruling on the fund's compensation for lost assets further to the Lehman default please refer
to the following links:
http://www.amf-france.org/documents/general/8815 1 .pdf;
http://www.amf-france.org/documents/general/arr%EAt cda_2008_22218.pdf
http://www.amf- france.org/documents/general/arr%EAt cda 2008_22085.pdf

[44] Please refer to the following link :
http://www.cssf.lu/uploads/media/communique_madoffl 8110 9 0 1 .pdf.
and to the Luxembourg commercial court judgment issued last March 4, 2010.

Box 13

Differences between national supervisors' scope of competencies lead to an uneven supervisory framework, suggesting that such competences might be better harmonised. In the Commission's view, this remains a key issue to be addressed in order to fully achieve due levels of harmonisation in practice for the depositary function at the Community level.

2. Supervision by auditors

Linked to appropriate supervision of UCITS by competent authorities, is the requirement to audit and periodically certify the assets that are held in custody by the UCITS depositary. Indeed, most depositaries are already subject to an annual audit due to provisions in banking and investment services regulation at EU level. However, the existing UCITS Directive does not require any periodic certification of the assets held on behalf of the UCITS in order to ascertain the true existence of the assets in the custody network.

The absence of such certification, for example by a depositary's auditors, was revealed to be an important deficiency in the context of the Madoff fraud.[45] Such certification would improve the level of investor protection. This has been addressed in the AIFM Directive, which states that depositaries and designated sub-custodians should be subject to periodic external audits, so as to ensure that financial instruments are in their possession.

Box 14

The introduction of a requirement for an annual certification of the assets held in custody by the depositary would clarify the true existence of such entrusted assets. This annual certification could be performed by the depositary's auditors. Details related to any such requirement might need to be further defined in implementing measures or technical standards as appropriate.

E. Other issues

1. Derogation from the obligation of UCITS to appoint a depositary

Article 32(4) and 32(5) of the UCITS Directives provide to Member States an option for an investment company not to appoint a depositary, where it markets a significant part of its shares through one or more stock exchanges under certain conditions[46].This option

[45] For information, the US regulator launched a proposal to introduce annual certification of the service providers' accounts by an independent and registered auditor. The EU legal framework under the Markets in Financial Instruments Directive also imposes similar obligations on credit institutions and investment firms holding clients assets - a requirements that Member States have already implemented with respect to investments firms.

[46] Directive: 2009/65/EC.· OJ L 302, 17.11.2009, p. 32-96 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF

was introduced in the original text of the 1985 Directive, and no equivalent provision exists for UCITS that does not take the form of an investment company.

However, there is no difference in the kinds of assets these two forms of UCITS can invest in to warrant such a difference in treatment. To a similar extent, the fact that UCITS shares are marketed through a stock exchange does not mean its holders are not subject to similar safekeeping risks, not does it justify the reason why these UCITS shareholders should not benefit from a similar level of protection. All UCITS investors should be able to expect an equivalent level of protection and the listing of the shares of an investment company cannot be taken to sufficiently mitigate the additional risks to investors addressed in this paper.

Box 15

It is suggested to delete articles 32 (4) and 32 (5) of the UCITS Directive n°2009/65/EC.

2. Single depositary rule

The CESR response to the 2009 Commission's consultation revealed that: "a *detailed definition of safekeeping and, notably, the first of the two elements constituting such a definition, clearly implies that all the assets of UCITS funds can only be entrusted to one depositary. Indeed, CESR recalls that the UCITS depositary must have an exhaustive and complete overview of the funds' assets to be in a proper position to perform its supervisory duties. However, as this principle is crucial, it could be clarified in EU legislation. This is without prejudice to Article 113(2) of the new Directive*. In other words, the directive should expressly mention that only one single depository can be appointed per UCITS.

The AIFM Directive proposes a more explicit approach and expressly states that: "For *each AIF it manages, the AIFM shall ensure that a single depositary is appointed in*

"An investment company's home Member State may decide that investment companies established on its territory which market at least 80 % of their units through one or more stock exchanges designated in their instruments of incorporation are not required to have depositaries within the meaning of this Directive provided that their units are admitted to official listing on the stock exchanges of those Member States within the territories of which the units are marketed, and that any transactions which such an investment company may effect out with stock exchanges are effected at stock exchange prices only. The instruments of incorporation of an investment company shall specify the stock exchange in the country of marketing the prices on which shall determine the prices at which that investment company will effect any transactions out with stock exchanges in that country. A Member State shall avail itself of the derogation provided for in the first subparagraph only if it considers that unit-holders have protection equivalent to that of unit-holders in UCITS which have depositaries within the meaning of this Directive. Investment companies referred to in this paragraph and in paragraph 4, shall, in particular: (a) in the absence of national law to this effect, state in their instruments of incorporation the methods of calculation of the net asset values of their units; (b) intervene on the market to prevent the stock exchange values of their units from deviating by more than 5 % from their net asset values; (c) establish the net asset values of their units, communicate them to the competent authorities at least twice a week and publish them twice a month. At least twice a month, an independent auditor shall ensure that the calculation of the value of units is effected in accordance with the law and the instruments of incorporation of the investment company. On such occasions, the auditor shall ensure that the investment company's assets are invested in accordance with the rules laid down by law and the instruments of incorporation of the investment company."

accordance with the provisions set forth below." This principle is essential to ensure that the depositary is in a position to keep sight over all the assets and cash transaction of the UCITS portfolio.

Box 16

It is suggested that the requirement for a single depositary per UCITS should be clarified (without prejudice to Article 113(2) of the UCITS Directive n°2009/65/EC).

3. Organisational requirements and rules of conduct

On the rules applicable to conflicts of interest, the UCITS Directive focuses on principles of independence between the fund manager and the depositary.[47] However, the Directive does not contain any more specific rules of conduct applicable to UCITS depositaries. The AIFM directive proposes, by contrast, to clarify the general rules of conduct applicable to all alternative funds depositaries: "*In the context of their respective roles, the AIFM and the depositary shall act honestly, fairly, professionally, independently and in the interest of the AIF and the investors of the AIF. A depositary may not carry out activities with regard to the AIF or, as the case may be, the AIFM on behalf of the AIF that may create conflicts of interest between the AIF, its investors, the AIFM and the relevant entity acting as a depositary, unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF.* "

There are similar discrepancies with regards to the organisational requirements applicable to UCITS depositaries.[48] In practice, requirements at the national level have been developed in some jurisdictions by simply applying to the depositary function the organisational requirements that exist for other investment services, but different Member States have taken different approaches.[49] Some Member States have aligned

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[47] UCITS Directive 2009/65/EC, Article 25 provides: *"no single company shall act as both Management Company and depositary (...) in the context of their respective roles the management company and the depositary shall act independently and solely in the interest of the unit-holders", Article 13 (e) states "a mandate with regard to the core function of investment management must not be given to the depositary or to any other undertaking whose interests may conflict with those of the management company or the unit-holders".*

[48] UCITS Directive 2009/65/EC, Article 25 provides: "*no single company shall act as both Management Company and depositary (...) in the context of their respective roles the management company and (…)*", Article 25 provides:" *The law or the fund rules shall lay down the conditions for the replacement of the management company and the depositary and rules to ensure the protection of unit-holders in the event of such replacement".*

[49] So far, MIFID organisational requirements are only applicable to MIFID firms and with respect to the MIFID services they provide. The management of UCITS is not a MIFID investment service. The depositaries are not MIFID firms *per se.* MIFID organisational requirements may only apply to MIFID Investment Firm that provide safekeeping and custody services that are linked to an investment service they provide.

their depositary organisational requirements on MiFID, while others have implemented specific organisational standards.[50]

Box 17

It is suggested to:

- Introduce for UCITS depositaries similar rules of conduct as in the AIFM Directive, in addition to the already existing rules stated in the article 22 and 32 of the UCITS Directive;

- Introduce implementing measures in order to encourage a higher degree of harmonisation and consistency between the organisational requirements applicable to all functions of the UCITS depositary (safekeeping as well as oversight) and, where appropriate, the existing MiFID requirements.[51]

4. Exchange of information with competent authorities

The UCITS Directive currently provides that "*the depositary shall enable the competent authorities of the UCITS home Member State to obtain, on request, all information that the depositary has obtained while discharging its duties, and that is necessary for the competent authorities to supervise compliance of the UCITS with this Directive".* Therefore, on the basis of this provision competent authorities cannot request any information but only such information which is necessary for the competent authorities to supervise compliance of the UCITS with the UCITS Directive.
The financial crisis has recently illustrated the need for supervisors to get rapid access to information which depositaries possess in order to have an accurate view over the situation of the UCITS markets. The absence of possibility for supervisors to get such general information can strongly impact their ability to take all necessary action in time of crisis.

This element has already been taken into consideration during the negotiation of AIFM Directive which provides for a more general rule, notably that the AIF depositary should make available to its competent authorities all information that may be necessary for the competent authorities of the AIF or AIFM.

Box 18

It is suggested to amend existing requirements concerning the disclose of information to the competent authorities, on their request, in such a way that any information, obtained by a depositary while carrying out its duties, should be made available to its competent authorities if such information may be necessary for these authorities.

[50] Please refer to CERS Mapping available at: http://www.cesr.eu/index.php?docid=6473.

[51] http://ec.europa.eu/internal_market/securities/isd/investor_en.htm

Implementing measures should also be introduced in order to, for example to detail the conditions and procedures under which UCITS depositaries shall exchange information with their supervisors.

5. *The contract between the depositary and the UCITS manager*

Both article 23(5) and article 33(5)[52] were recently introduced in the UCITS Directive provide additional safeguards in the context of the management company passport. It is now obligatory for a management company managing a fund on a remote basis to enter into a written agreement with a depositary (located in the fund domicile). This obligation has not been duplicated for situations where both [i.e. management company and depositary] entities are located in the same Member State. National rules often require however those in the domestic context managers and depositaries also enter into such an agreement.[53]

Also, as mentioned in the feedback statement[54] of the Commission first consultation on the UCITS depositary function launched in 2009, although existing organisational requirements at national level or in industry guidelines are clear enough, it was considered that if organisational requirements were to be harmonised, they should be aligned and consistent with existing MiFID organisational requirements, where appropriate. With regard to conflicts of interest, it was considered that these rules should be clarified where the asset manager and the depositary belong to the same group and that transparency for final investors should be enhanced.

This element has already been taken into consideration during the negotiation of AIFM Directive which provides for general organisational requirements applicable to the AIF depositary.

Box 19

It is suggested that the requirements set out in Article 23(5) and Article 33(5) of the UCITS Directive and their corresponding implementing measures should also apply to a situation where the management company home Member State is also a UCITS home Member State.

It appears opportune to require the UCITS depositary to follow conduct of business rules

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[52] "*Where the management company's home Member State is not the UCITS home Member State, the depositary shall sign a written agreement with the management company regulating the flow of information deemed necessary to allow it to perform the functions set out in Article 22 and in other laws, regulations or administrative provisions which are relevant for depositaries in the UCITS home Member State.*"

[53] Please refer to CESR's response to the 2009 consultation on the UCITS depositary function. http://www.cesr.eu/index.php?docid=6064
For information, The AIFM directive already introduces such contractual requirements between manager and depositaries domiciled in the same member state.

[54] http://ec.europa.eu/internal_market/consultations/2009/ucits_depositary_function_en.htm

which would oblige a depositary to act honestly, fairly, professionally, independently and in the interest of the UCITS and investors of the UCITS. Furthermore, the depositary should be required to establish appropriate policy for identification, management, monitoring and disclosure of the conflict of interests which may arise when a depositary carries out activities with regard to the UCITS.

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Beyond these proposals, do you consider that any additional measures, other than those set out in this Consultation Paper, should be introduced, to reflect (i) the specificities of the UCITS depositary function and (ii) the objective of maintaining a high level of investors' confidence? Please support any proposals with supporting explanations and evidence and objective data where relevant.

Evidence is particularly sought as to whether similar approaches or processes to the ones described in this document in box 1 to 5 and box 11 to 18 , are already being used in practice by depository organisations or already required according to national laws and regulation. Details on the precise extent are sought to aid the Commission in assessing the impact of requiring such approaches or processes at the European level. As regards to box 6 to 10, additional detailed data is sought on the proportion of UCITS assets which are today safekept by sub-custodians, sub-custody networks, etc, so that an assessment of the impact of stricter liability requirements in relation to such assets might be made.

Throughout, please provide details of the costs and benefits that possible changes may create (and any other additional changes you may propose). Provide as much concrete data and explanatory material as you are able.

2. UCITS MANAGERS' RENUMERATION POLICIES

2.1. International commitments

Remuneration and incentive schemes within financial institutions have been one of the key factors that contributed to the financial crisis that erupted in 2008, in so far as they contributed significantly to excessive risk-taking by incentivising an expansion of the volume of trades aimed at maximising short-term returns over longer term value creation.[55] It was acknowledged at the G20 Summit in London that remuneration schemes needed to be tackled and all 'agreed to endorse and implement the Financial Stability Forum's tough new principles on pay and compensation schemes, as well as on the corporate social responsibility of all firms'.[56] On the basis of this mandate the Financial Stability Board (FSB) issued in September 2009 Principles for Sound Compensation Practices (Implementation Standards). The FSB confirmed[57] that official actions to address unsound compensation systems must be embedded in the broader financial regulatory reform program. It highlighted the importance of coherent action in all major financial centres and stressed the need for effective, global implementation of the Principles, as only their rigorous and consistent implementation by significant financial institutions throughout the world can ensure a level playing field and restore confidence in the markets.

2.2. EU initiatives

2.2.1. Commission Recommendation of April 2009

Soon after the publication of the de Larosière Report (February 2009), the Commission indicated in its Communication of 4th March 2009 on 'Driving the European recovery' that it would strengthen its 2004 Recommendation on the remuneration of directors of listed companies and table a new Recommendation on remuneration in financial services to address perverse incentives and excessive risk taking throughout firms. The latter Recommendation was adopted on 20th April 2009. It aims at addressing shortcomings pertaining to the structure of remuneration policies which failed to align employees' incentives with the long-term objectives of a company as well as inappropriate internal control systems. The Recommendation also addresses the issue of insufficient oversight by competent authorities of the risks posed by inappropriate remuneration policies.[58] A Commission recommendation was adopted as this allowed for rapid intervention over a short time frame, owing to the urgency of taking steps in this area. However, it was clear that new binding requirements for the horizontal application of the Recommendation would have to follow.[59]

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[55] Report of the High-Level Group on Financial Supervision in the EU Chaired by Jacques de Larosière, Brussels, 25 February 2009, p. 10

[56] The Global Plan for Recovery and Reform, 2 April 2009, point 15.

[57] FSB's Principles for Sound Compensation Practices (Implementation Standards), 25.09.2009, p. 1.

[58] In this context inappropriate remuneration policies should be understood as policies which facilitate excessive short-term risk taking by companies.

[59] In the Communication accompanying the Recommendations the Commission acknowledged that recommendations were only the first stage in the Commission's strategy to address this issue.

The Commission Report on the application by Member States of the Commission Recommendation on remuneration policies in the financial services sector[60] indeed showed substantial differences in the approaches of Member States to the Recommendation: only sixteen Member States had applied the measure, though to different extents; six were in a process of adjusting their national legislation; while a relatively high number of Member States had not initiated any measures or had taken unsatisfactory ones. Only seven Member States applied relevant measures across the whole financial services sector. Not surprisingly the Report concluded that further efforts were needed in order to bring firms' remuneration policies into line with the principles stated in the aforementioned Recommendation. Consequently, it announced further steps the Commission intended to take, including, 'ensuring a swift agreement of co-legislators on the pending legislative proposals that deal with remuneration issues and proposing similar legislative measures on remuneration in the non-banking financial services sector (insurance, UCITS) in the course of 2010/early 2011'.

2.2.2. New rules on remuneration for banks and investment companies

In July 2009, the Commission adopted a proposal to revise the Capital Requirements Directive (CRD)[61] tackling, inter alia, remuneration policies of credit institutions which, by virtue of Directive 2006/49/EC, would apply also to investment firms within the meaning of MiFID.[62] The banking sector (including investment banks) have been at the focus and in the front line of the Commission's first steps, as inappropriate remuneration practices in this sector were considered most material in incentivising excessive, short-term risk-taking and in contributing to significant losses by certain of these financial undertakings, aggravating systemic problems and market unrest.[63]

Following the political agreement reached in the Council, the European Parliament voted in favour of the amending Directive on 7 July 2010. The proposed changes aim at translating the principles contained in the Recommendation into legally binding requirements. The draft Directive also reflects the FSB Implementation Standards, thereby contributing to a coherent application of rules on remuneration policy at a global level. Banking supervisors have been required to oversee remuneration policies and effectively sanction non-compliance. The new provisions on remuneration should be applicable from 1 January 2011. They will apply to remuneration awarded in 2010 where this has not been paid by the effective implementation date of the provisions in Member States. [64]

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[60] Report from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions on the application by member States of the EU of the Commission 2009/384/EC Recommendation on remuneration policies in the financial services sector

[61] COM(2009)362

[62] New requirements on the remuneration policy which will be laid down in Article 22 and in Annex V to the Directive 2006/48/EC will also apply to MiFID firms as art. 34 and 37 of Directive 2006/49/EC refer directly to art. 22 of Directive 2006/48/EC,

[63] Detailed explanation of the problem can be found in the Impact Assessment accompanying document for the Proposal for a Directive amending Capital Requirements Directive on trading book, securitization issues and remuneration policies, SEC(2009)975 final, p. 17.

[64] Annex to this consultation paper provides a comparison between requirements on remuneration contained in amended CRD Directive with provisions on remuneration as proposed for AIFM Directive.

2.2.3. Rules on remuneration for insurance companies

The Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) agreed, in its Advice to the Commission,[65] that the high-level principles of remuneration policies developed for banks should also apply to the insurance sector. In October 2009 CEIOPS provided the Commission with a list of principles for achieving a better alignment between overall risk management and the remuneration of personnel working in the insurance sector, reflecting specificities of the insurance sector where relevant. Rules on remuneration will constitute a part of the level 2 measures under the Solvency II Directive. The adoption process will most likely end in June 2011.

2.2.4. Green Paper on Corporate Governance

In June 2010 the Commission published a Green Paper on Corporate Governance in financial institutions and remuneration policies.[66] This addresses corporate governance practices and rules within financial institutions, in the context of Commission's wider programme of financial market reform oriented towards addressing crisis prevention and mitigation issues. The Green Paper aimed at exploring options which could accompany and supplement existing requirements, including those covered by the UCITS Directive. The conclusions deriving from these public consultations may also feed into the considerations on the legislative proposal on the remuneration requirements for UCITS.

2.3. Need for a remuneration policy for UCITS managers

The UCITS asset management sector was not one of the root causes of the financial crisis, and the new regulatory framework for UCITS should place significant limits on the degree and nature of the risk that a UCITS might take on, thereby also limiting the extent to which misaligned incentives might lead to wider systemic problems.

Nonetheless, the Commission services see strong arguments in favour of applying sound remuneration principles to UCITS managers. In particular, the Commission services would like to stress the following aspects:

- New products and techniques making UCITS more vulnerable

The growing use of more complex and sophisticated strategies and access to more exotic investments, coupled to an increase in the usage of performance fee structures (that provide a mechanism for putting in place individual remuneration policies linked to fund performance), suggests that UCITS might not be entirely immune from remuneration structures that may incentivise managers to take on undue levels of risk, as identified elsewhere in the financial services.

- Level playing field

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[65] CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Remuneration Policy, October 2009,CEIOPS-DOC-51/09; http://www.ceiops.eu/media/files/consultations/consultationpapers/CP59/CEIOPS-DOC-51-09%20L2-Advice-Remuneration-Issues.pdf

[66] COM(2010)284 final, 2.06.2010.

Inconsistencies in remuneration requirements applying to different entities could lead to market distortion issues. Both the Commission proposal on remuneration for banks and investment firms (by means of CRD III) and the incorporation of remuneration provisions by the co-legislators into the AIFM Directive imply a consequential need for a level playing field between these entities and UCITS managers. The asset management sector is a core conduit for investment flows, with potentially a very significant impact on wider markets. In general, it is clear that problems occurring in one sector will have inevitable impacts on other segments of the market, and overall financial stability can only be ensured where similar safeguards are put in place across the whole system. Secondly, if UCITS managers were left relatively unregulated in this area this could lead to regulatory arbitrage, and possibly the migration of more risky practices into the UCITS sector (in so far as the UCITS framework allows). The Commission services are of the view that sectoral legislation should ensure consistent and effective remuneration policies across all financial services in order to avoid a distortion of competition between different sectors competing for attracting similar talents on the same labour market.[67]

- Impact of consistency in requirements across sectors on Groups

UCITS managers may also manage other types of collective investment scheme, or carry out certain other activities[68]. They also can act Europe-wide. Asset managers who are part of larger groups are also often constrained to comply with a harmonised group-wide remuneration structure for reasons of global consistency and equal treatment.[69]

Against this background, it is envisaged that the UCITS Directive should be adapted to include requirements on sound remuneration principles for UCITS managers. Furthermore, these requirements should be consistent with those proposed for the managers of AIFs as well as for banks and investment firms. A harmonised approach to remuneration policy would entail similar (though not necessarily identical) principles for all relevant entities. This would not only create a level playing field, but it would also lessen costs of compliance as compared with maintaining different standards.

2.4. Suggested changes in the UCITS Directive

2.4.1. Focus on effective risk taking and prevention of conflict of interests

The Commission services are of the view that principles of the sound remuneration policy require some tailoring when applied to individual sectors – this applies for banks and investment firms, but also for UCITS managers; the specificities of the asset

[67] Report from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions on the application by member States of the EU of the Commission 2009/384/EC Recommendation on remuneration policies in the financial services sector (p. 3).

[68] According to article 6(3) of Directive 2009/65/EC UCITS management companies can be authorised to provide services of individual portfolio management as well as investment advice and safekeeping and administration in relation to units of collective investment undertakings.

[69] EFAMA's contribution to the Commission request for information on remuneration practices in the asset management industry, August 2010.

management sector need to be taken into account so as to ensure the effectiveness of these principles. Unlike in banks, where excessive risk taking has in some cases undermined entire institutions, thereby endangering the stability of the whole sector, the scale and nature of risk taking by fund managers is by necessity more limited, given the constraints on the fund manager set by the fund's investment strategy and the UCITS framework more widely. Furthermore, the UCITS Directive together with its implementing measures contains comprehensive risk management and measurement requirements which aim at minimising the risks that investors can be exposed to when investing in UCITS (other than those that are intrinsic to a particular investment policy and strategy).

CESR noted in its advice to the Commission,[70] that 'remuneration practices may strongly hamper sound and effective risk management if oriented towards rewarding short-term profits and giving staff incentives to pursue unduly risky activities. Management companies should establish remuneration policies in a way as to ensure that it does not induce risk taking which is inconsistent with the risk profiles, fund rules or instruments of incorporation of the UCITS they manage (…)'.

CESR also advised that the remuneration policy applied to UCITS managers should be such that it 'should not, and is not likely to, lead to conflicts of interest'; it should be 'designed in such a way as to avoid conflicts of interest and ensure the independence of the persons involved'.

CESR also recommended that it be ensured that 'the remuneration and incentive structure for the staff is consistent with principles related to the protection of the interests of clients and investors in the course of collective portfolio management activities and other services provided'.

The AIFM Directive approached the application of the general principles of remuneration policy to asset management business along similar lines, and required that the AIFM should have remuneration policies (…) that are 'consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles, fund rules or instruments of incorporation of the AIF it manages'.

It is suggested that remuneration policies for UCITS managers should be designed to:

- Promote sound and effective risk management, and discourage any risk-taking which is inconsistent with the risk profiles, fund rules of instruments of incorporation of the managed UCITS;

- Prevent conflicts of interest;

[70] In October 2009 CESR advised the Commission to include principles of the remuneration policy into the set of requirements on organisational procedures and arrangements of the UCITS managers. This suggestion formed part of CESR's technical advice to the Commission on the level 2 measures related to the UCITS management company passport. This advice aimed at assisting the Commission in its decision-making process on the scope and content of the level 2 measures to the UCITS Directive. Though the Commission's view concurs with the CESR advice, it was decided not to include these suggestions in the level 2 measures under the UCITS Directive, as it considered that the importance of such requirements would require a level 1 legislative measure.

- Ensure the protection of the interests of clients and investors in the course of collective portfolio management activities and other services provided.

2.4.2. Scope of application - to whom requirements should apply

The Commission services consider that the obligations relating to remuneration policies should apply to the UCITS fund manager (which may be a management company or a self-managed investment company). The remuneration policy should cover remuneration of any type paid to the staff of the manager, whether paid by the management company or directly by the fund. (Please see also the description of the PRIPs workstream, page 5 of this Consultation Paper, as this workstream addresses possible conflicts of interest where a product is being sold, which can include issues relating to remuneration from a more specific angle).

The Commission Recommendation specifies that the 'remuneration policy should apply to those categories of staff whose professional activities have an impact on the risk profile of the financial undertaking'.

CESR in its advice to the Commission took a similar position and recommended that 'the remuneration policy should be applied to the staff whose activities materially impact the risk profile of UCITS managed by the management company'.

The CRD III is more detailed on this issue, and lists examples of the categories of staff to which such policy should apply: for instance 'senior management, risk takers, control functions, any employee receiving total remuneration that takes them into the same remuneration brackets as senior management and risk takers (…)'. Similarly the rules on remuneration under AIFM Directive apply to those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profiles of AIF they manage

It is suggested that in the case of UCITS managers, remuneration policies should apply to those categories of staff whose professional activities may have a material impact on the risk profile of a managed UCITS, in particular to senior management including a board of directors, persons carrying out supervisory functions or the permanent risk management function, and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management.

2.4.3. Proportionate application of sound remuneration principles

The Commission Recommendation recognizes that the principles of sound remuneration policy may be applied differently according to the size, internal organisation and the nature, scope and the complexity of the activities of relevant entities.

The CRD also upholds the proportionality principle, so that banks and investment firms can apply the rules on remuneration in a way which is proportionate to the nature, scale and complexity of their activities[71].

The AIFM Directive also allows for certain flexibility in the application of the remuneration principles. Annex II point 1 states that "AIFM shall comply with [these principles] in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities".

It is suggested that UCITS managers should be given similar flexibility, so that they could apply the principles of sound remuneration policy in a manner proportionate to their size, internal organisation as well as the nature, scale and complexity of the activities carried out by the UCITS manager and the managed UCITS.

2.4.4. Governance issues: elaboration, review and disclosure of the remuneration policy

The remuneration policy and in particular its elaboration, review and disclosure, form part of the governance issues. The duties related to the elaboration of the remuneration policy, its implementation and review are clearly assigned to particular bodies/functions in accordance with the internal structures and related division of competences within a management company.

The Commission Recommendation suggests that it is for the supervisory board to determine the remuneration of directors and establish the general principles of the remuneration policy, with the assistance of control functions and remuneration committees. The supervisory board, as referred therein, should also take responsibility for its implementation. The implementation of the remuneration policy should be subject to central and independent internal review at least annually, for compliance with policies and procedures for remuneration. CESR suggested in its advice to the Commission that the compliance function and, where applicable, internal audit, should be involved in the design and review of the implementation of the remuneration policy and report to the supervisory function on any material weaknesses and shortfalls.

The transparency of the remuneration policy can be understood to include both internal transparency and external disclosure. With regard to the first dimension, the Commission Recommendation includes the principle that procedures for determining remuneration should be clear, documented and internally transparent. Furthermore, the general principles of the remuneration policy should be accessible to all staff members to whom they apply. As to external disclosure, the Recommendation states that: 'without prejudice to confidentiality and data protection provisions, relevant information on the remuneration policy (…) should be disclosed by the financial undertaking in a clear and easily understandable way to relevant stakeholders'. Also in this context CESR suggested that, as a matter of best practice, the remuneration policy could be made available on the website of the management company.

[71] Refer to art. 22(2) of Directive 2006/48/EC)

The draft legislative proposals (CRD III and AIFM Directive) broadly follow these recommendations with the exception of external disclosure.

Taking into account the recommendations mentioned above, rooted in the principles of good governance, it is suggested to include the following requirements for UCITS managers in relation to the internal organisation and procedures:

- The management body in its supervisory function should adopt the general principles of the remuneration policy and be responsible for the implementation and periodical review of these principles;

- The permanent compliance function should review, at least annually, how the remuneration policy is implemented and whether its implementation complies with the general principles of the remuneration policy;

- A remuneration committee should be established where it is justified by the size of a UCITS manager and a UCITS it manages ('significant size' criterion), their internal organisation and the nature, scope and the complexity of their activities. The role of the remuneration committee would be to exercise an independent judgment on remuneration policies and practices;

- The principles of the remuneration policy should be accessible to staff members to whom they apply.

2.4.5. Elements of the remuneration structure

The Commission Recommendation contains several principles concerning the structure of remuneration systems. They relate to the variable or fixed components of bonuses, circumstances where bonuses or parts of them should be deferred, how a bonus is structured, and in what circumstances bonuses or their parts might be repaid.

These principles, though to the different extents, have been included in the annexes to both CRD III and AIFM Directive.

It is suggested that principles relating to remuneration structures should be adapted so as to take into account UCITS managers' business models. They should address the following elements:

- Criteria for calculating compensation for different categories of staff in cases where remuneration is performance-related, including the time element in assessing the performance;

- Rules for guaranteed variable remuneration (which might be allowed only in the context of hiring new staff, and should be limited in time);

- Rules for fixed and variable components of total remuneration (restrictions on variable remuneration, deferral of a portion of variable remuneration etc.);

- Rules on pension benefits;

- Rules for payments related to the early termination of contract.

* * *

1. Comments on the suggestions included in this Consultation Paper concerning the remuneration policy for UCITS management or investment companies are welcome.

In particular:

a) Do you agree that to maintain a level playing field in the financial services sector, remuneration policy for UCITS management or investment companies should broadly follow similar rules contained in the AIFM Directive or CRD III, so as to ensure a consistent approach to remuneration policy across all financial sectors? If not, please explain and justify your views.

b) Do you agree that the proposed approach to the regulation of remuneration policy for UCITS managers includes all requirements that should be covered? Can you identify any other options or approaches that might be more effective?

c) Do you consider certain requirements more important than others?

d) Do you believe that certain principles, or elements of these, are not suitable for UCITS managers or not appropriately tailored? If so, please suggest alternative ways of tailoring the general principles.

Please justify or explain your answer and provide supportive evidence.

2. Are there any additional changes than those suggested in this Consultation Paper that should be introduced as regards remuneration policy for asset managers? Please justify or explain your answer and provide objective data to support it.

3. Please provide us with any evidence you may have on the likely scale and nature of impacts that the suggested rules on remuneration policy may create for UCITS managers and other stakeholders.

* * *

3. CONCLUDING REMARKS

The Commission expects this consultation exercise to finalise the development of an informed and evidence-based proposal on the range of UCITS depositary and remuneration issues which are addressed in this paper. This will permit a better appreciation of how European policy towards UCITS depositaries should best evolve.

Responses to the consultation are requested **online**, by **31 January 2011**.

Responses can be addressed to **markt-depository-consultation@ec.europa.eu**

Annex

Rules on remuneration policy – table comparing provisions contained in the AIFM Directive and CRD III

AIFM Directive	**CRD III**
Art. 13(1) first subparagraph Member States shall require AIFM to have remuneration policies and practices for those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profiles of AIF they manage, that are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles, fund rules or instruments of incorporation of the AIF it manages. The AIFM shall determine the remuneration policies and practices in accordance with what is set forth in Annex II.	Article 1 point (2)(a) Home Member State competent authorities shall require that every credit institution have robust governance arrangements, which include a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, adequate internal control mechanisms, including sound administration and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management.
	Article 1 point (2)(aa) 2b. Home Member State competent authorities shall use the information collected in accordance with the criteria for disclosure established in point 15(ea) of part 2 of Annex XII to benchmark remunerations trends. The competent authority shall provide the Committee of European Banking Supervisors with this information.
Article 13(2) ESMA shall ensure the existence of guidelines on sound remuneration policies which comply with the principles set out in Annex II. The guidelines shall also take into account the principles on sound remuneration policies set out in the Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector and shall take into account the size of the AIFM and the size of AIF they manage, their internal organisation and the nature, the scope and the complexity of their activities. ESMA shall cooperate closely with the European Banking Authority (EBA) established by Regulation (EU) no …/2010 of the European Parliament and of the Council of […] establishing a European Supervisory Authority (European Banking Authority)..	Article 1 point (2)(b) The Committee of European Banking Supervisors shall ensure the existence of guidelines on sound remuneration policies which comply with the principles set out in points 23 and 23a of Annex V. The guidelines shall also take into account the principles on sound remuneration policies set out in the Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector. The Committee of European Securities Regulators shall cooperate closely with the Committee of European Banking Supervisors in ensuring the existence of guidelines on remuneration policies for categories of staff involved in the provision of investment services and activities within the meaning of point 2 of Article 4(1) of Directive 2004/39/EC of the European Parliament and of the Council on

	markets in financial instruments. The Committee of European Banking Supervisors shall use the information received from competent authorities to benchmark remuneration practices at the Union level on the basis of information provided by competent authorities under paragraph 2b of this Article.
	Article 1 point (2)(ba) 3a. Home Member State competent authorities shall collect information on the number of individuals per credit institution in pay brackets of EUR 1 million and upwards including the business area involved and the main elements of salary, bonus, long-term award and pension contribution. This information shall be forwarded to the Committee of European Banking Supervisors and it shall disclose this information on an aggregate Home Member State basis in a common reporting format. The Committee of European Banking Supervisors may elaborate guidelines to facilitate the implementation of, and ensure consistency of information collected.
	Article 1 point (10n) By April 2013, the Commission shall review and report on the provisions on remuneration, including those set out in Annexes V and XII, with particular regard to their efficiency, implementation, enforcement, taking into account international developments. That review shall identify any lacunae arising from the application of the principle of proportionality to these provisions. The Commission shall submit this report to the European Parliament and the Council together with any appropriate proposals.
	Article 3(1) The laws, regulation, and administrative provisions necessary to comply with point 1 of Annex I shall require credit institutions to apply the principles therein to (i) remuneration due on the basis of contracts concluded before the effective date of implementation in each Member State and awarded or paid after that date, and to (ii) remuneration awarded, but not yet paid, before the date of effective implementation in each Member State, for services provided in 2010.

Annex II Remuneration Policy 1. When establishing and applying the total remuneration policies, inclusive of salaries and discretionary pension benefits, for those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile or the risk profiles of AIF they manage, AIFM shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities:	**Annex I (1) (Introduction of Section 11 'Remuneration Policies' to Annex V)** 23. When establishing and applying the total remuneration policies, inclusive of salaries and discretionary pension benefits, for categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile, credit institutions shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities:
(a) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking which is inconsistent with the risk profiles, fund rules or instruments of incorporation of the AIF it manages;	(a) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the credit institution;
(b) the remuneration policy is in line with the business strategy, objectives, values and interests of the AIFM and the AIF it manages or the investors of the AIF, and includes measures to avoid conflicts of interest;	(b) the remuneration policy is in line with the business strategy, objectives, values and long-term interests of the credit institution, and incorporates measures to avoid conflicts of interest;
(c) the management body in its supervisory function of the AIFM adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation;	(c) the management body in its supervisory function of the credit institution adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation;
(d) the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;	(d) the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;
(e) staff members engaged in risk management are compensated in accordance with the achievement of the objectives linked to their functions,	(da) staff members engaged in control functions are independent from the business units they oversee, have appropriate authority, and are compensated in

independent of the performance of the business areas they control;	accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;
f) the remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee;	(db) the remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee;
(g) where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit or AIF concerned and of the overall results of the AIFM, and when assessing individual performance, financial as well as non-financial criteria are taken into account;	(e) Where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution and when assessing individual performance, financial as well as non-financial criteria are taken into account.
(h) the assessment of performance is set in a multi-year framework appropriate to the life-cycle of the AIF managed by the AIFM in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the redemption policy of the AIF it manages and their investment risks;	(ea) the assessment of the performance is set in a multi-year framework in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks; (eb) the total variable remuneration does not limit the ability of the credit institution to strengthen its capital base;
(i) guaranteed variable remuneration is exceptional and occurs only in the context of hiring new staff and is limited to the first year;	(ec) guaranteed variable remuneration is exceptional and occurs only in the context of hiring new staff and is limited to the first year;
	(ed) in the case of credit institutions that benefit from exceptional government intervention: - Variable remuneration is strictly limited as a percentage of net revenues when it is inconsistent with the maintenance of a sound capital base and timely exit from government support, - The relevant competent authorities shall require credit institutions to restructure compensation in a manner aligned with sound risk management and long-term growth, including inter alia and when appropriate establishing limits to the remuneration of Directors. - No variable remuneration should be paid to the directors of that institution unless this is justified.

(j) fixed and variable components of total remuneration are appropriately balanced; the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component;	(f) fixed and variable components of total remuneration are appropriately balanced; the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component. Institutions should set the appropriate ratios between the fixed and the variable component of the total remuneration. The Committee of European Banking Supervisors shall ensure the existence of guidelines to set specific criteria to determine the appropriate ratios between the fixed and the variable component of the total remuneration;
(k) payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure;	(g) payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure;
(l) the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes a comprehensive adjustment mechanism to integrate all relevant types of current and future risks;	(h) the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes an adjustment for all types of current and future risks and takes into account the cost of the capital and the liquidity required; The allocation of the variable remuneration components within the credit institution shall also take into account all types of current and potential risks.
(m) subject to the legal structure of the AIF and its instruments of incorporation or fund rules, a substantial portion, which is at least 50 % of any variable remuneration shall consist of units or shares of the AIF concerned, or equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments. These instruments are subject to an appropriate retention policy designed to align incentives with the interests of the AIFM and the AIF it manages or the investors of the AIF. Member States or their competent authorities may	(ha) a substantial portion, which is at least 50 % of any variable remuneration shall consist of an appropriate balance of: (i) shares or equivalent ownership interests, subject to the legal structure of the credit institution concerned, or share-linked instruments or equivalent non-cash instruments in case of a non-listed credit institution, and (ii) where appropriate, other instruments within the meaning of article 66 paragraph 1a letter a), where

place restrictions on the types and designs of these instruments or ban certain instruments as appropriate. This point shall be applied to both the portion of the variable remuneration component deferred in line with point (m) and the portion of the variable remuneration component not deferred.	applicable that adequately reflect the credit quality of the credit institution on an ongoing concern. These instruments are subject to an appropriate retention policy designed to align incentives with the longer-term interests of the credit institution. Member States or their competent authorities may place restrictions on the types and designs of these instruments or ban certain instruments as appropriate. This point shall be applied to both the portion of the variable remuneration component deferred in line with point (i) and the portion of the variable remuneration component not deferred. haa) The Committee of European Banking Supervisors shall ensure the existence of guidelines to specify instruments that can be eligible as instruments within the meaning of paragraph ha(ii) that adequately reflect the credit quality of credit institution within the meaning of paragraph ha).
(n) a substantial portion, which is at least 40 % of the variable remuneration component, is deferred over a period which is appropriate in view of the life cycle and redemption policy of the AIF concerned and is correctly aligned with the nature of the risks of the AIF in question. This period should be at least three to five year unless the life cycle of the AIF concerned is shorter; remuneration payable under deferral arrangements vests no faster than on a pro-rata basis; in the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount is deferred;	(i) a substantial portion, which is at least 40 % of the variable remuneration component is deferred over a period which is not less than three to five years and is correctly aligned with the nature of the business, its risks and the activities of the member of staff in question . Remuneration payable under deferral arrangements vests no faster than on a pro-rata basis. In the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount is deferred. The length of the deferral period is established in accordance with the business cycle, the nature of the business, its risks and the activities of the member of staff in question.
(o) the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the AIFM as a whole, and justified according to the performance of the business unit, the AIF and the individual concerned; the total variable remuneration is generally considerably contracted where subdued or negative financial performance of the AIFM or of the AIF concerned occurs, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or claw back arrangements;	(ia) the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned; Without prejudice to the general principles of national contract and labour law, the total variable remuneration is generally considerably contracted where subdued or negative financial performance of the firm occurs, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements.

(p) the pension policy is in line with the business strategy, objectives, values and long-term interests of the AIFM and AIF it manages. If the employee leaves the AIFM before retirement, discretionary pension benefits should be held by the AIFM for a period of five years in the form of instruments as defined in point (m). In case of an employee reaching retirement, discretionary pension benefits should be paid to the employee in the form of instruments defined in point (m) subject to a five year retention period.	(ib) the pension policy is in line with the business strategy, objectives, values and long-term interests of the credit institution. If the employee leaves the credit institution before retirement, discretionary pension benefits should be held by the credit institution for a period of five years in the form of instruments as defined in point (ha). In case of an employee reaching retirement, discretionary pension benefits should be paid to the employee in the form of instruments defined in point (ha) subject to a five year retention period.
(q) staff members are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;	(ic) staff members are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;
(r) variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of this Directive;	(id) variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of this Directive;
	(ie) These principles are applied by credit institutions at group, parent company and subsidiary levels, including those established in offshore financial centres.
2. The principles set out in paragraph 1 shall apply to the remuneration of any type paid by the AIFM, to any amount paid directly by the AIF itself, including carried interest, or to any transfer of shares or units of the AIF, made to the benefits of those categories staff, including senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile or the risk profiles of the AIFs they manage.	
3. AIFM that are significant in terms of their size or the size of the AIF they manage, their internal organisation and the nature, the scope and the complexity of their activities shall establish a remuneration committee. The remuneration committee shall be constituted in a way that enables it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk.	22a. Credit institutions that are significant in terms of their size, internal organisation and the nature, the scope and the complexity of their activities shall establish a remuneration committee. The remuneration committee shall be constituted in such a way as to enable it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk, capital and liquidity

The remuneration committee shall be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the AIFM or the AIF concerned and which are to be taken by the management body in its supervisory function. The remuneration committee shall be chaired by a member of the management body who does not perform any executive functions in the AIFM concerned. The members of the remuneration committee shall be members of the management body who do not perform any executive functions in the AIFM concerned.	The remuneration committee shall be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the credit institution concerned and which are to be taken by the management body in its supervisory function. The Chair and the members of the remuneration Committee shall be members of the management body who do not perform any executive functions in the credit institution concerned. When preparing such decisions, the remuneration committee shall take into account the long-term interests of shareholders, investors and other stakeholders in the credit institution