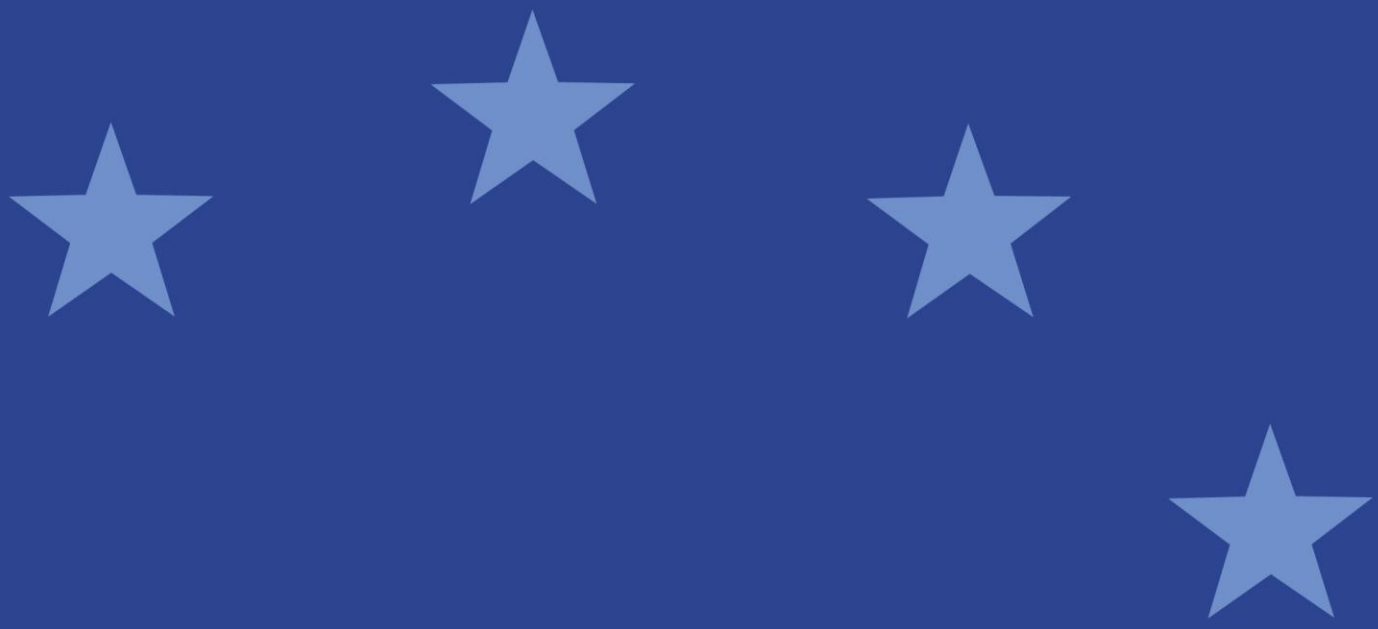
esma European Securities and Markets Authority

Reply form for the Technical Advice the on delegated acts required by the UCITS V Directive



26 September 2014

European Securities and Markets Authority

Date: 26 September 2014

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Consultation Paper - ESMA's technical advice to the European Commission on delegated acts required by the UCITS V Directive, published on the ESMA website (here).

Instructions

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, please follow the instructions described below:

i. use this form and send your responses in Word format;

ii. do not remove the tags of type < ESMA_UCITS_QUESTION_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and

iii. if you do not have a response to a question, do not delete it and leave the text "TYPE YOUR TEXT HERE" between the tags.

Responses are most helpful:

i. if they respond to the question stated;

ii. contain a clear rationale, including on any related costs and benefits; and

iii. describe any alternatives that ESMA should consider

Given the breadth of issues covered, ESMA expects and encourages respondents to specially answer those questions relevant to their business, interest and experience.

To help you navigate this document more easily, bookmarks are available in "Navigation Pane" for Word 2010 and in "Document Map" for Word 2007.

Responses must reach us by **24 October 2014**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input/Consultations'.

Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Disclaimer'.

III. Advice on the insolvency protection of UCITS assets when delegating safekeeping (Art. 22a(3)(e)[1] and 26b(e) UCITS V)

Q1: Do you agree that the steps to be taken by the third party are ultimately intended to ensure that the level of segregation foreseen under 22a(3)(d) of the UCITS Directive is recognised in the context of an insolvency proceeding involving the third party?

<ESMA_UCITS_QUESTION_1>
Yes.
<ESMA_UCITS_QUESTION_1>

Q2: Do you consider that the level of segregation foreseen under Art 22a(3)(d) of the UCITS Directive should protect UCITS assets from claims by creditors of an insolvent third party which had been delegated the safekeeping of the assets by the UCITS' depositary?

<ESMA_UCITS_QUESTION_2>
Yes
<ESMA_UCITS_QUESTION_2>

Q3: Are there other measures which could also help achieve this objective?

<ESMA_UCITS_QUESTION_3>
TYPE YOUR TEXT HERE
<ESMA_UCITS_QUESTION_3>

Q4: Do you agree with the steps to be taken by the third party as identified above? If not, please explain the reasons.

<ESMA_UCITS_QUESTION_4>
Not totally. In particular, although we think that the third party should (letter iv of Point 1(b) of ESMA's advice on page 26 of ESMA's advice) maintain appropriate arrangements to safeguard the UCITS' rights in its assets and minimise the risk of loss and misuse, it would go too far to require it to "*analyse how certain actions or decisions could materially change the status of the UCITS' assets and/or complicate return of the UCITS' assets, such as if the exercise of a right of re-use or enforcement of a pledge – to the extent that this is authorised under Article 22(7) of Directive 2009/65/EC – results in a different party succeeding to rights in the UCITS' assets.*"

We understand and share the aim of this detailed requirement, but it will be very difficult to put it in place in practice and may result in adverse consequences for asset managers.

Indeed, depositaries will have difficulties in finding sub-custodians able to manage such a specific requirement since from our experience no local law firm is likely to opine on the absence of risk of loss or misuse of the UCITS assets while exercising the right of re-use or enforcement of a pledge notably.

Furthermore, such requirement would necessarily extend the time necessary for the depositary to accept a sub-custodian and may jeopardize the investment decision in a new country either for timetable reason or for lack of certainty as to the absence of risk.

[1] Article 22a(3)(d) in the text of UCITS V published in the Official Journal.

From a practical perspective, this will lead to the exclusion of some markets from the scope of investments of the asset managers and will be to the advantage of major depositaries with large sub-custodians network while in fine the depositary bears the responsibility of the return of the UCITS assets and is in charge to make its own due diligence and evaluate the risk when accepting a new sub-custodian.

<ESMA_UCITS_QUESTION_4>

Q5: Do you consider that there are any specific difficulties that may arise in verifying the applicable insolvency regime that makes the proposed rules difficult to be complied with? In particular, do you consider the requirement for the third party located in a jurisdiction outside the Union to obtain independent legal advice could give rise to specific issues?

<ESMA_UCITS_QUESTION_5>
No, apart from, potentially, the one mentioned right above.

<ESMA_UCITS_QUESTION_5>

Q6: Do you expect a significant increase in terms of costs that would be faced by the third party delegated entities located in jurisdictions outside the Union in order to obtain independent legal advice on the applicable insolvency regime? If yes, please provide any available data and/or estimation.

<ESMA_UCITS_QUESTION_6>
No.
<ESMA_UCITS_QUESTION_6>

Q7: Would you suggest requiring the third party to take any further steps which are not foreseen in the draft advice?

<ESMA_UCITS_QUESTION_7>
No.
<ESMA_UCITS_QUESTION_7>

Q8: Should any specific consideration be given to the scenario where the third party further sub-delegates the safe-keeping of the UCITS' assets in accordance with Article 22a(3), last sub-paragraph of the UCITS Directive (as inserted by UCITS V)? Should the third party take any additional/different steps or measures in this case?

<ESMA_UCITS_QUESTION_8>
No.
<ESMA_UCITS_QUESTION_8>

Q9: Do you agree with the steps to be taken by the depositary as identified above? If not, please explain the reasons.

<ESMA_UCITS_QUESTION_9>
Yes.
<ESMA_UCITS_QUESTION_9>

Q10: Do you expect any significant one-off and ongoing compliance costs for depositaries in order to take the steps identified above? If yes, please provide any available data and/or estimation.

<ESMA_UCITS_QUESTION_10>
No.
<ESMA_UCITS_QUESTION_10>

Q11: Would you suggest requiring the depositary to take any further steps which are not foreseen in the draft advice?

<ESMA_UCITS_QUESTION_11>
No.
<ESMA_UCITS_QUESTION_11>

Q12: Which measures do you think should be taken by the depositary and/or the investment company/management company in the best interest of the investors once the depositary has informed the investment company or the management company on behalf of the UCITS that the segregation of the UCITS' assets in the event of insolvency of the third party is no longer guaranteed in a given jurisdiction located outside the Union? Would the transfer of the relevant UCITS' assets held by the third party in a non-EU jurisdiction to another (EU or non-EU) jurisdiction which recognises the segregation of the UCITS' assets in the event of insolvency of the third party/depositary be a possible measure?

<ESMA_UCITS_QUESTION_12>
Yes, this transfer could be a possible measure, but it will depend also from the local rules which are applicable – and therefore this principle of cross-border transfer of assets might encounter legal difficulties in practice.

Regarding the drafting of the proposed ESMA's advice on page16, we would suggest to clarify the letter (iii): instead of "*shall not change the nature of the assets*", it should be read as: "*shall not change the **legal** nature of the assets.*", as otherwise the understanding of this provision is difficult.
<ESMA_UCITS_QUESTION_12>

IV. Advice on the independence requirement (Art. 25(2) and 26(b)(h) UCITS V)

Q13: Do you agree with the identified links that may jeopardise the independence of the Relevant Entities? If not, please explain the reasons.

<ESMA_UCITS_QUESTION_13>
No.

In our opinion, in the context of independence of asset management companies vis-à-vis their depositaries, some ESMA proposals seem to exceed the provisions of the Level 1 UCITS V Directive. **Level 1 provisions seem already very clear**. At Level 1, Article 25 paragraph 2 states: "*In carrying out their respective functions, the management company and the depositary shall **act** honestly, fairly, professionally, **independently** and solely in the interests of the UCITS and the investors of the UCITS. In carrying out their respective functions, the investment company and the depositary shall act honestly, fairly, professionnally, independently and solely in the interests of the investors of the UCITS.*" This provision makes clear that **the notion of independence does not have to be approached from a structural perspective, but clearly from an operational perspective**.

Therefore, some draft proposals from ESMA go clearly beyond what the Level 1 is requiring, in particular:

- **the so-called Option 1 proposed for cross-shareholdings on page 22 of ESMA's draft advice**

- **the second part of Option 2 on the same topic, on page 23 and 24 of ESMA's draft advice.**

IOSCO's Consultative Paper issued on 10th October regarding the custody of collective investment scheme assets fully support our view, from a worldwide perspective:

IOSCO takes the right direction and insists on the need for functional independence between the depositary and the management company. They describe what it means and what should be done. It is exactly the route ESMA should explore to explain what means "acting" independently – which is what Level 1 requires.

IOSCO also makes a very relevant reference to the distinction between functional and structural independence – they do not require the latter to be put in place.

IOSCO's statements are very clear:

"*Principle 4 – the custodian should be functionally independent from the responsible entity.*"

"According to Principle 25 of the IOSCO Principles, it is not mandatory (…) for the custodian and the responsible entity to not have common shareholders or directors (…)."

Regarding specifically conflicts of interest, there are already general provisions which are covering the topic. If needed, it could be envisaged – as it is the case in France – that external auditors state on an annual basis that depositaries comply in full independence with the requirements applicable to them.

From a systemic perspective, imposing a depositary from a group different from the asset management company's one might end with concentrating the systemic risks among very few custodians.

From a competition perspective among depositaries, such a concentration would also probably end with an oligopoly generating higher costs for funds and their investors.

ESMA proposals exceed the provisions of the Level 1 UCITS V Directive. Level 1 provisions seem already very clear. At Level 1, Article 25 paragraph 2 states: "*In carrying out their respective functions, the management company and the depositary shall **act** honestly, fairly, professionally, **independently** and solely in the interests of the UCITS and the investors of the UCITS. In carrying out their respective functions, the investment company and the depositary shall act honestly, fairly, professionally, independently and solely in the interests of the investors of the UCITS.*"

This provision makes clear that the notion of independence does not have to be approached from a structural perspective, but clearly from an operational perspective.

Therefore, some draft proposals from ESMA go clearly beyond what the Level 1 states.

<ESMA_UCITS_QUESTION_13>

Q14: Do you consider that any additional links should be taken into account such as, for instance, the existence of any contractual commitment or other relationship which would affect the independence of the Relevant Entities? If yes, please provide details.

<ESMA_UCITS_QUESTION_14>
No.
<ESMA_UCITS_QUESTION_14>

Q15: Do you consider that the cumulative presence of all or some of the identified links is necessary to jeopardise the independence of the Relevant Entities or the presence of any of these links is sufficient to determine a lack of independence?

<ESMA_UCITS_QUESTION_15>
The notion of independence must be assessed in the action of the relevant entities, as stated at Level 1, not in the structural links of these entities.

<ESMA_UCITS_QUESTION_15>

Q16: Do you agree with the proposed option to ensure the separation of the management bodies/bodies in charge of the supervisory functions of the Relevant Entities?

Do you have any alternative options to suggest, taking into account those identified under paragraph 47?

<ESMA_UCITS_QUESTION_16>
No. The notion of independence must be assessed in the action of the relevant entities, as stated at Level 1, not in the structural links of these entities.

From this perspective, the existing rules on the management of conflicts of interest, already tested for many years, are sufficient. In practice, very few examples of failures occurred, and in any case it would be disproportionate to impose to the whole European UCITS management industry a provision which aims to solve the very few cases which occurred in the past.

<ESMA_UCITS_QUESTION_16>

Q17: Do you consider that the cap of one third of members of the body in charge of the supervisory functions of one of the Relevant Entities to also be members of the management body, the body in charge of the supervisory functions or employees of the other Relevant Entity is appropriate? Would you suggest any alternative percentage? If yes, please provide the reasons why.

<ESMA_UCITS_QUESTION_17>
No. Once again, the independence must be assessed through the action of the relevant entities, and the structures should not have to be reformed to impose a new model which has no clear justification.

For instance in the US, where independent Directors have been existing for long, major failures occurred in many instances: late trading, market timing, etc. – as by definition independent Directors are not involved in the daily operations. And conversely in Europe, only very few failures occurred in entities without such independent Directors – introducing such a requirement would be disproportionate.

<u>Therefore we are supporting ESMA's draft advice only for letters (a) and (b) on page 22 of the advice:</u>

(a) no member of the management body of the management company/investment company shall be a member of the management body of the depositary;
(b) no member of the management body of the management company/investment company shall be an employee of the depositary and no member of the management body of the depositary shall be an employee of the management company/investment company;

Conversely, we consider that letters (c) and (d) imposing a minimum proportion of independent members is not relevant as counter-examples can be found in the US and as it would be disproportionnate for the vast majority of European UCITS management companies.

What is needed is to follow a functional approach of independence (in conformity with the Level 1 Directive) and not a structural approach.

And if a breach of this lack of independence occurs in practice, then it will be the responsibility of regulators to sanction it.

<ESMA_UCITS_QUESTION_17>

Q18: Do you have knowledge of any restructuring in the composition of the management bodies/bodies in charge of the supervisory functions of any Relevant Entities that would be triggered by the identified option? If yes, please provide data and an estimation of the one-off and ongoing costs that would be incurred.

<ESMA_UCITS_QUESTION_18>
TYPE YOUR TEXT HERE
<ESMA_UCITS_QUESTION_18>

Q19: Which of the two identified options do you prefer? Would you suggest any alternative option? If yes, please provide details.

<ESMA_UCITS_QUESTION_19>
We are clearly against Option 1, as to our knowledge in Europe very few cases of failures occurred due to this issue.

However, Option 2, although being preferable, should be amended:

- We fully support letter (e) and the first part of letter (f):

  (e) the management company/investment company shall put in place a robust decision-making process for choosing the depositary which shall be based on objective pre-defined criteria and meet the exclusive interest of the UCITS;
  (f) in case any of the following situations arise:
  - the depositary has a direct or indirect holding in the management company/investment company which represents 10 % or more of the capital or of the voting rights or which makes it possible to exercise a significant influ-

ence over the management of the management company/investment company in which that holding subsists; or
- the management company/investment company has a direct or indirect holding in the depositary which represents 10 % or more of the capital or of the voting rights or which makes it possible to exercise a significant influence over the management of the depositary in which that holding subsists; or
- the management company/investment company and the depositary are included in the same group for the purposes of consolidated accounts, as defined in Directive 2013/34/EU or in accordance with recognised international accounting rules,

*["**at least**": **to be deleted**] the following arrangements shall be put in place:*

(i) all reasonable steps to avoid conflicts of interest arising from the shareholding or group structure shall be taken and, when they cannot be avoided, conflicts of interest shall be identified, managed and monitored and, where applicable, disclosed, in order to prevent them from adversely affecting the interests of the UCITS and their investors;

and

(ii) the choice of the depositary shall be justified to investors upon request.

- But we don't agree:
    - In the last part of letter (f), with the mention "*at least*", which leaves to much uncertainty on the final requirements which might be required from one Member State to another
    - with letter (g), related to the reference to independent members of the relevant bodies. We think that this provision is not in line with the functional approach clearly stated in the Level 1 Directive, and goes also beyond what IOSCO is proposing at worldwide level.

<ESMA_UCITS_QUESTION_19>

Q20: Under the second option, do you consider that it would be appropriate to require that – whenever the Relevant Entities are part of the same group – at least one third of the members of the management body of the management company/investment company and depositary should be independent? Would you suggest any alternative percentage? If yes, please provide the reasons why.

<ESMA_UCITS_QUESTION_20>
No. See above.
<ESMA_UCITS_QUESTION_20>

Q21: Do you agree that the concept of independence should be understood as requiring that independent directors should not be member of the management body or the body in charge of the supervisory function nor employees of any of the undertakings within the group?

<ESMA_UCITS_QUESTION_21>
No. See above.
<ESMA_UCITS_QUESTION_21>

Q22: Do you have knowledge of the impact that each of the two options identified would have in terms of restructuring the shareholding of any Relevant Entities or finding alternative service providers? If yes, please provide data and an estimation of the one-off and ongoing costs that would be incurred.

<ESMA_UCITS_QUESTION_22>
TYPE YOUR TEXT HERE
<ESMA_UCITS_QUESTION_22>

Annex III

Cost-benefit analysis

Q23: Do you agree with ESMA's approach to discard the second and third options described above?

<ESMA_UCITS_QUESTION_23>
TYPE YOUR TEXT HERE
<ESMA_UCITS_QUESTION_23>