Financial Services User Group's (FSUG)

response

on the UCITS depositary function and on the UCITS managers' remuneration

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INTRODUCTION

FSUG is pleased to submit its comments to this important review. This submission should be read in conjunction with our submissions on PRIPs, IMD and sanctions.

FSUG's primary objective is to promote investment markets that meet the needs of investors and society, not just the commercial needs of the industry. This requires markets that:

- investors have justified confidence in;
- are secure and stable;
- operate fairly, transparently and with integrity;
- are competitive and efficient; and provide access to value-for-money, socially useful products and services.

To meet these objectives, FSUG considers that all investment-based products and services (regardless of legal or corporate structure) should be covered by a coherent, consistent regulatory regime for investment services. This regime should apply to all parts of the investment 'supply chain', not just those parts who deal directly with investors.

Regulatory reforms should ensure:

- All agents in the investment supply chain, including those who do not deal directly with investors or undertake activities that are not visible to investors, operate to a high level duty of care to investors.
- Legal and corporate structures of investment products are secure and transparent, with assets valued and audited on a regular basis by independent third parties. Investors are informed clearly about the legal and regulatory jurisdiction of investment products being marketed to them.
- Corporate governance standards in the investment industry are improved to ensure all parts of the investment supply chain treat investors fairly. Senior directors (and shareholders) must take responsibility for corporate governance and be accountable for their actions.
- Information provided to investors should be of a consistently high quality, and easy to understand. Investors should receive clear, relevant information post-sale, not just pre-sale and at the point of sale. Investors' financial circumstances and attitudes to risk change over time.
- Consumers receive advice on the most appropriate product/investment vehicle for their needs, not the product that suits the commercial needs of the firm or intermediary. Advisers/intermediaries should be required to operate to a general high level duty of care when assessing consumers' needs and level of financial sophistication (where possible). To ensure this happens, the Commission should review and produce clear guidelines about (i) needs assessment (for example, information gathering/'know your customer' requirements) to be followed in Member State regulations, and (ii) professional standards expected of intermediaries/advisers.
- Conflicts of interest such as commission driven sales and other aggressive remuneration practices that are the root cause of most mis-selling scandals must be addressed by a robust regulatory response (information disclosure is necessary but not sufficient to counter aggressive selling practices or reckless behaviour).
- The investment industry is competitive, efficient and provide value for money, socially useful products.
- A level playing field between different types of provider and products to ensure fair and effective competition.

- Regulation is risk based and proportionate – interventions should be proportionate to the potential for consumer detriment, i.e. the duty of care, advice requirements, product standards and regulation should be matched to the complexity of the product, riskiness of the product, sales practices, distribution tactics, remuneration policies (for example, if firms are using aggressive remuneration policies linked to staff achieving sales targets) to involved.
- Regulators and supervisors have the necessary powers (and culture) to adopt an early-intervention approach to prevent consumer detriment and market failure occurring in the first place. Prevention is much more cost-effective and better at promoting consumer confidence.

Therefore, we support the overall aims and proposals set out in this consultation document and other separate initiatives covering MiFID and PRIPs. If implemented in a timely and consistent manner, these reforms should make a significant contribution towards meeting the objectives set out above.

As a more general point, we argue that the much needed coherent, consistent regulatory regime for all investment services would be best achieved by an omnibus directive covering legal and corporate structures, sales and distribution, conduct of business, conflicts of interest, product design, and professional competence of intermediaries, of all products with an investment purpose regardless of legal or corporate structure.

Policymakers and regulators have a problem dealing with market 'innovation'. Too often, regulators are slow to respond to an emerging market innovation or practice which causes consumer detriment. By the time, the regulatory process has been completed, the practices that cause detriment may have stopped and a new form of detriment emerges. This is not helped by the 'silo' approach adopted by EU and national regulators – where regulatory policy is formulated and implemented according to legal and corporate structure of products and providers rather than according to consumer needs (a prime example is the way UCITS, MiFID, IMD, and PRIPs have evolved over time).

UCITS DEPOSITARIES

GENERAL COMMENTS

FSUG generally agrees with the proposed measures set out in the Commission document.

UCITS are one of the most important retail investment products for consumers. Savers invest their money directly in UCITS and indirectly by purchasing unit-linked life insurance policies. UCITS regulation comprises provisions that are important to retail investors such as diversification of assets, pre-contractual information (prospectus agreement, KIID), periodic information, and depositary functions.

It is encouraging that policymakers are paying attention to the legal security and basic safekeeping of assets. This is just as critical to investor protection as more obvious point-of-sale requirements such as conduct of business, marketing and promotion of products.

It is critical that risks such as fraud, mismanagement, negligence, default of investment firm and so on are managed by strong regulation. Therefore, the safe-keeping and oversight functions of the depositary are very important.

The nature of safekeeping and custodian services means that day-to-day responsibility for undertaking these activities are often outsourced or sub-contracted to specialist firms – in many cases to firms located outside the investor's jurisdiction. This makes it difficult for consumers to identify and understand the potential risks associated with the geographical spread of an investment company which establishes different parts and units of the company in different Member States.

Therefore, we support the recommendation that the UCITS depositary should be responsible for the loss of assets in case of failure of a sub-custodian.

An example of the detriment incurred by retail investors could be seen with an Austrian investment firm based in Austria but SICAV-funds were denominated in another Member State. In 2005, retail investors incurred heavy losses (over EUR 100 million), mainly due to fraud and criminal activities of the management.

In addition to this, the role of the depositary bank has been seriously questioned. In particular, doubts have been raised about whether comprehensive accounting principles and the eligibility of repayments of shares on the SICAV-funds were (fully) applied by the depositary bank.

It is important that product providers are not able to benefit from regulatory arbitrage. Therefore, FSUG supports the view that the scope of national supervisors' competencies should be harmonised.

As a matter of principle and practice, FSUG believes that it is better to prevent detriment occurring in the first place rather than clean up after the event. Preventative regulation requires early warning and information sharing.

Therefore, we propose that an institutionalised information sharing process be established between consumers, supervisory authorities and deposit/guarantee schemes. Emerging problems – in particular conspicuous providers, products or company structure – should be addressed in a defined dialogue framework and pursued if necessary or in case of doubt. In particular, consumer protection associations and organisations – on the strength of their experience in advising consumers in financial service matters could provide valuable insights into consumer experiences and market practices. This right to be heard might be more materially stipulated in future.

We would also emphasise that it is critical to address conflicts of interests that exist between UCITS managers and UCITS depositaries belonging to the same group. In this case, it will always be difficult for the depositary's staff to exert its oversight function and take measures against the UCITS manager.

COMMENTS ON SPECIFIC ISSUES

1.A. Depositary's duties

1.A.1. Safe-keeping

Box 1

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

As mentioned by the Commission in its document, the Madoff fraud and the Lehman default have demonstrated that the differences and inconsistencies in the rules applicable to the depositaries have created legal and technical uncertainties that may be detrimental to the UCITS holders and their confidence in this important retail investment product.

Therefore, there is a real need for a consistent, coherent, and robust system of regulation covering safe-keeping of assets. This system of regulation should apply to the basic definition of activities and responsibilities as well as corporate behaviours.

Box 2

It is envisaged to complete Articles 22 and 32 of the UCITS Directive 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.*
- *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. 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.*

FSUG agrees with the suggestion to make the UCITS directive consistent with the approach of the AIFMD regarding the provisions mentioned in Box 2.

The segregation requirement should also be applied when the depositary delegates its custodian functions to a sub-custodian.

1.A.2. Oversight functions

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).

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.

FUSG agrees with the suggestions mentioned by the Commission in Boxes 3 and 4.

1.A.3. Delegation of the depositary's tasks

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

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.

FSUG considers that only safe-keeping duties could be entrusted to a third party.

Retail investors generally do not have the knowledge to understand and evaluate the risk linked to using a network of sub-custodians. S/he is not the one who chooses the sub-custodian and cannot assess if the choice made by the depositary is the best solution. Technical information on the risk is not of great help for the retail investor.

We consider that the risks linked to the sub-custodian network have to be supported by the depositary. If the risks are too high to be supported by the depositary, the investment in that particular asset that needs a sub-custodian should be reconsidered by the UCITS manager.

The due diligence duty when appointing a sub-custodian on an ongoing basis is necessary. The due diligence will be quite more efficiently performed if it protects the depositary firm than if it is to protect the unit holder.

1.B. UCITS depositary liability regime

1.B.1. Improper performance

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.

We agree with the measure suggested in Box 6.

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

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.

We agree with the measure suggested in Box 7.

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

Box 8

As already provided under Articles 22 and 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 majeure'.

FSUG agrees with the recommendation that the UCITS depositary should be responsible for the loss of assets in case of failure of a sub-custodian.

As mentioned above, we consider that the risks linked to the sub-custodian network have to be supported by the depositary. If the risks are too high to be supported by the depositary, the investment in that particular asset that needs a sub-custodian should be reconsidered by the UCITS manager.

Allowing for a contractual possibility for the depositary to be discharged of its liability or even introducing an automatic discharge of responsibility where assets are kept by sub-custodian are not acceptable for retail investors.

To avoid divergent or extensive national interpretations, the 'force majeure' exception should be harmonised, preferably with some examples.

1.B.4. Burden of proof

Box 9

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

We would argue that if the depositary is liable for all assets loss except in case of 'force majeure', there is no need to have specific provision about the burden of proof for the safe-keeping duty of the depositary.

With regards to the supervisory duty, FSUG agrees that the AIFMD provision inversing the burden of proof should be extended to the UCITS Directive. This is a key requirement as – due to the high technicality – retail investors have a huge disadvantage when problems occur.

1.B.5. Rights of UCITS holders' action against the UCITS depositary

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.

We agree with the measure suggested in Box 10

C. Eligibility criteria

1.C 1. Eligibility criteria

Box 11

It is suggested to introduce an exhaustive list of entities that should be eligible to act as UCITS depositaries, 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).

FSUG agrees with the suggestion made in Box 11.

However, existing UCITS depositary institutions which are neither credit institutions nor authorised MiFID firms and also provide the ancillary service of safe-keeping and administration of financial instruments should adopt one of the eligible entities type. We would prefer it if there was no grandfathering but in any case there should be a time limit of 2 years for the grandfathering clause.

1.C.2. Location of the depositary (passport issues)

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.

We agree.

1.D. Supervision issues

1.D.1. Supervision by national regulators

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.

We agree with the suggestion to harmonise the scope of national supervisors' competencies.

1.D.2. Supervision by auditors

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.

Due to the importance of the depositary's functions in the framework of protecting the retail investor FSUG considers that the assets held in custody should be certified by the depositary's auditor.

That measure could also improve the confidence in the UCITS brand.

1.E. Other issues

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

Box 15

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

We support the measure in Box 15 as this should promote a more consistent and coherent regulatory system.

1.E.2. Single depositary rule

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 2009/65/EC).

We support the proposal in Box 16 to ensure responsibilities of depositaries are clarified and understood.

1.E.3. Organisational requirements and rules of conduct

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 Articles 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.*

FSUG supports the proposal in Box 17. We are concerned about the conflicts of interests existing between UCITS managers and UCITS depositaries belonging to the same group. If that is the case, it will always be difficult for the depositary's staff to exert its oversight function and take measures against the UCITS manager. Our view is that 'Chinese walls' do not offer enough guarantee when both manager and depositary serve the same shareholders, or even have same directors.

1.E.4. Exchange of information with competent authorities

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. 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.

We agree with the measure suggested in box 18. In particular, it is important that regulators determine the information supplied to authorities and the conditions and procedures for exchanging information.

1.E.5. The contract between the depositary and the UCITS manager

Box 19

It is suggested that the requirements set out in Articles 23(5) and 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 23 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.

FSUG very much supports the requirement for a mandatory written agreement between the UCITS manager and its depositary.

As mentioned under Box 17, we are concerned about the conflicts of interests existing between UCITS managers and UCITS depositary belonging to the same group. It seems illusory that they could really act independently as suggested when they serve the same shareholders. In the first place, conflicts of interests should be prevented, disclosure remains the last choice.

It is important that conflicts of interest are addressed at all parts of the financial supply chain, including those agents and activities that are not visible to investors.

UCITS MANAGERS REMUNERATION POLICIES

GENERAL COMMENTS

FSUG strongly agrees with the view that remuneration and incentive schemes within financial institutions have been one of the key factors that contributed to the financial crisis that erupted in 2008.

Aggressive remuneration policies introduce conflicts of interest that undermine duties of care to clients and due diligence and contribute 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.

Indeed, there is a strong prima facie case for arguing that the remuneration policies and reward systems prevalent in the financial markets undermines one of the fundamental purposes of our financial system – that is, the allocation of capital and other financial resources to the most productive and socially useful economic activities.

Dysfunctional reward systems are one of the root causes of market failure and consumer detriment within the financial system and at each stage of the financial supply chain. As we mention above in the Introduction, we are confident that focusing on dysfunctional reward systems would allow policymakers and regulators to intervene and prevent detriment from occurring in the first place.

It is important to note the emphasis we place on the impact of reward systems at each part of the financial supply chain, not just in terms of financial stability. Aggressive reward systems are recognised as one of the root causes of market failure and consumer detriment for 'ordinary' investors – for example, mis-selling of inappropriate products and distorting competition.

Therefore, we fully support the aims of the EU to address this issue across the financial system and specifically within the UCITS regime. However, we emphasise that it is important that these reforms are applied coherently and consistently across all investment services and to all parts of the financial system.

RESPONSE TO SPECIFIC QUESTIONS

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

In particular:

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.

We agree that remuneration policies for UCITS management or investment companies should be consistent with those in the AIFM Directive and CRD III. Coherence and consistency are important to promote a level playing field for competition, and prevent regulatory arbitrage.

However, it is important that policies are of sufficiently high standard not just consistent.

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?

Do you consider certain requirements more important than others?

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.

Yes. We agree with proposed approach set out in the Consultation Paper. It is important that senior directors and board members take responsibility and are held accountable for risk management throughout the firm including remuneration policies.

Risk management and remuneration policies should be fully transparent to:

- promote good corporate governance and accountability; and
- allow shareholders and investors to exercise due diligence.

As part of risk management, supervisors should be able to withhold approval of remuneration policies if they consider these to encourage undue risk taking or reckless behaviour.

Supervisors should ensure that remuneration policies take into account complaints data and compliance breaches, and are not just linked to financial targets. We believe this would be an effective way of aligning the interests of managers and investors.

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.

No further comments.