



European Securities and
Markets Authority

Final Report

ESMA's technical advice to the European Commission on delegated acts required by the UCITS V Directive

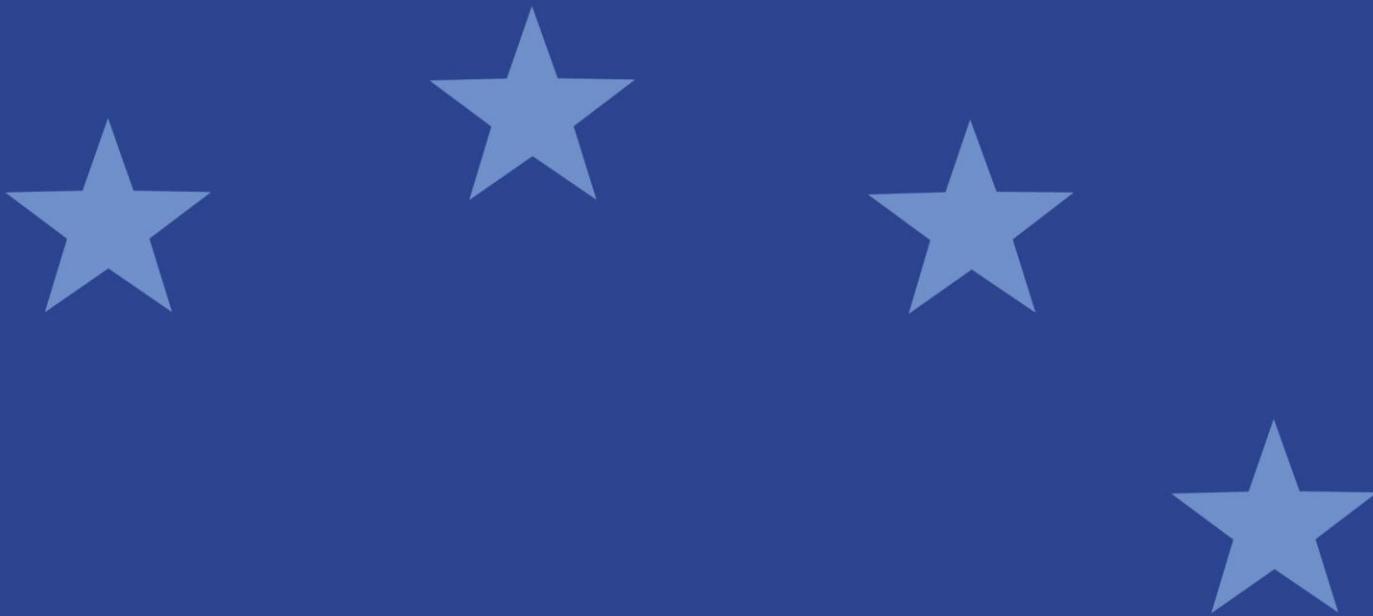




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1 Executive Summary

Reasons for publication

On 3 July 2014 ESMA received a provisional request from the European Commission for technical advice on the content of two of the delegated acts on depositaries required by UCITS V. ESMA published a consultation paper on 26 September setting out the draft technical advice on those delegated acts. That consultation closed on 24 October. This report sets out ESMA's final advice to the Commission in light of the feedback from stakeholders.

Contents

This report sets out ESMA's views on possible implementing measures regarding the issues identified in the European Commission's request. Section 2 gives feedback on the consultation. The Commission's original request can be found in Annex 3.1, followed by the cost-benefit analysis in Annex 3.2. The formal advice is contained in the boxes in Annex 3.3 of the paper.

Advice on the insolvency protection of UCITS assets when delegating safekeeping

UCITS V provides that, when the custody functions are delegated by the depositary to a third party, such a third party shall take "*all necessary steps to ensure that in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among or realisation for the benefit of creditors of the third party*". The European Commission is empowered to adopt delegated acts specifying the steps to be taken by the third party pursuant to these provisions. This section of the advice proposes measures, arrangements and tasks for the third party to which custody is delegated as well as measures to be put in place by the depositary.

Advice on the independence requirement

UCITS V states that "*In carrying out their respective functions, the management company [and the investment company] and the depositary shall act [...] independently and solely in the interest of the UCITS and the investors of the UCITS*". The European Commission is empowered to adopt delegated acts specifying the conditions for fulfilling this independence requirement. This section of the advice identifies two types of link between the management company/investment company and the depositary (namely (a) common management/supervision and (b) cross-shareholdings between these entities) which may jeopardise their independence and recommends measures to address the risks that may arise.

Next Steps

ESMA will cooperate closely with the European Commission in view of the transformation of the technical advice into formal delegated acts.

2 Feedback on the consultation

1. ESMA received 60 responses to the consultation paper (CP) on ESMA's technical advice to the European Commission on delegated acts required by the UCITS V Directive. Responses were received from asset managers (and their associations), depositaries/banks (and their associations), consumer representatives, public authorities, a law firm, an academic, and an individual.

I. General comments

2. Two asset management associations regretted the short deadline given for responses to the consultation. They were of the view that the narrow timelines given to ESMA for producing its draft advice seriously compromised what should be, from the Commission's perspective, an objective exercise that would allow it to justify its policy choices in line with its internal impact assessment guidelines.
3. Two asset management associations were of the view that it was important to ensure that the Level 2 measures would be applied in the same way throughout the Union and, therefore, national competent authorities should refrain from imposing additional requirements in their respective jurisdictions (i.e. "gold plating").
4. One of these associations also recommended that consistency be ensured between the UCITS Level 2 measures and the corresponding measures under the AIFMD.
5. In relation to the use of the definition of 'management body' under Article 2 of the UCITS Directive, the same respondent was of the view that the advice should better distinguish between executive and non-executive functions within the management body, especially in the context of avoiding or managing conflicts of interest.
6. The following requests to clarify terms were made:
 - a) 'third party': some depositaries (and their representatives) argued that it should be made clear that this concept does not cover central securities depositaries (CSDs); several other respondents mentioned that confusion can arise from the use of this term where sub-delegation takes place;
 - b) 'segregation': some respondents asked for clarification that Articles 22a(3)(c) and (d) permit the use of omnibus accounts at sub-custodians.
7. A depositary mentioned the implications of the extent of the segregation obligation for collateral management services.

ESMA response: Regarding the deadline given to respondents to reply to the consultation, as mentioned in the CP, this was triggered by the deadline set by the European Commission for ESMA to provide its technical advice. In order to make provision for a public consultation (albeit a short one), ESMA decided to deliver its advice after the deadline set by the Commission (i.e. by end-November rather than 15 October).

On the gold-plating issue, see the response below under Q19.

On the requests to provide further clarifications on certain terms, ESMA considers that the request relating to the term 'segregation' goes beyond the scope of the present advice (the same being true for the request to ensure consistency with the AIFMD Level 2 measures, as the mandate given to ESMA to provide technical advice was confined to a limited number of the UCITS Level 2 empowerments). The request relating to the term 'third party' did not seem to deserve any further specification as it should be clear from the Level 1 text that these terms refer to any entity to whom depositary duties are delegated in accordance with the provisions of the UCITS Directive.

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

Measures, arrangements and tasks for the third party to which custody is delegated

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?

8. The large majority of respondents (including consumer representatives) agreed 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.
9. On the requirements under 22a(3)(d) of the UCITS Directive, one respondent was of the opinion that 'separation' does not necessarily have to be achieved using separate accounts.
10. Another respondent disagreed that the goal of the segregation obligation is to protect the assets in case of an insolvency proceeding against the custodian.

ESMA response: Given the broad support received from those respondents who replied to this question, ESMA decided not to change its approach on this aspect.

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?

11. Five respondents disagreed, with some of them arguing that changes may arise in local insolvency laws and jurisprudence.
12. The majority of respondents (including consumer representatives) agreed that the level of segregation foreseen under Article 22a(3)(d) of the UCITS Directive should protect UCITS assets from claims by creditors of an insolvent third party. Similarly, an asset management association agreed that the provision in Article 22a(3)(d) of the UCITS

Directive is naturally linked with the provision of Article 22a(3)(e). Another respondent was of the view that separation as defined under Article 22a(3)(d) is sufficient for assets to be segregated in the event of insolvency.

13. An asset management association agreed that investor protection schemes for retail investors can only be kept affordable and manageable if assets are kept as insolvency proof as possible.
14. While agreeing with the views of ESMA, a number of respondents noted that the protection ensured by segregation is subject to any development in insolvency laws and jurisprudence. Similarly, a depositary association pointed out that, notwithstanding the due diligence conducted by the depositary and the legal advice obtained, based on past experience, the laws of many jurisdictions do not ensure that the return of clients assets is not hindered or delayed or even brought into the insolvent estate of the third party.
15. Several respondents (including asset managers, depositaries and their associations) encouraged ESMA and the European Commission to support harmonisation at international level (i.e. IOSCO) of the insolvency laws in third country jurisdictions so as to deliver effective asset segregation and protection.
16. A depositary suggested replacing the word 'guarantee' with the word 'recognise' in paragraphs 2(b)(ii) and (iii) of the draft advice on the basis that applicable insolvency laws will never guarantee a particular outcome.

ESMA response: Given the broad support received from those respondents who replied to this question, ESMA decided not to change its approach on this aspect.

ESMA saw merit in the suggestion to replace the word 'guarantee' with the word 'recognise' in order to have consistency throughout the relevant parts of the advice.

On the request to ESMA to support harmonisation at international level, ESMA is supportive of the idea of harmonising insolvency laws in third countries. However, this is not part of ESMA's mandate per se and would more appropriately be taken forward by IOSCO or the European Commission.

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

17. Some respondents considered that there are no additional measures that could help achieve the objective.
18. Several other respondents suggested additional measures. These included the following:
 - a) Depositaries must inform the UCITS manager and the competent authority of the UCITS where the requested level of protection from third party claims could no longer be guaranteed. Some of the respondents who suggested this measure also asked ESMA to develop guidelines on the action that should be taken by the depositary, the management company/UCITS and its competent authorities in these circumstances.

- b) The UCITS manager (or the UCITS itself, if self-managed) should take appropriate and prompt action and, where relevant, immediately sell the assets because in most instances it would be impossible for a depositary to find an alternative sub-custodian or local agent if there is an issue in a particular market. Several respondents suggested that there would be only two alternatives: (a) to dispose of the securities or (b) to convert the securities from a bearer form to a registered form (i.e. a security that is registered in the books of the issuer in the name of the owner).
- c) Depositaries should use blocked custody accounts for funds' assets (and a blocked bank account for cash belonging to the fund) so that a clear identification of beneficial ownership is possible, as foreseen under sec. 72 of the Capital Investment Act (KAGB).
- d) The steps outlined in the AIFMD Level 2 regarding review of local law and notification to investment managers of material deficiencies or uncertainties relevant to customer asset protection should be transposed to the UCITS regime.
- e) The depositary should make a disclosure to the UCITS and its management company that segregation is not recognised in the jurisdiction so that the risk is properly taken into account when making the investment decision.
- f) The depositary should have regard to measures in the local jurisdictions, to make the assets as "insolvency-proof" as possible based on local legal advice.
- g) The depositary should undertake appropriate levels of ongoing monitoring, which may include an enhanced level of credit monitoring or enhanced levels of reconciliation work or other measures to pick up any early warning signs of potential problems.

ESMA response: ESMA saw merit in amending the advice so as to place an obligation on the UCITS management company, on receipt of the information from the depositary, to notify immediately its competent authority of such information and take the appropriate measures in relation to the relevant assets of the UCITS, including their disposal taking into account the need to act in the best interest of the UCITS and the investors of the UCITS. Therefore, ESMA added a new paragraph 3 covering these topics in this part of the advice.

ESMA considered that most of the residual suggestions from those respondents who responded to this question were already covered by the provisions of this part of the advice.

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

- 19. The large majority of respondents agreed with the steps to be taken by the third party as identified by ESMA.
- 20. An asset management association pointed out that third parties outside the EU are not bound by the requirements of the UCITS Directive beyond the degree to which such

requirements are introduced in the contract appointing them. Another respondent argued that it is difficult to negotiate contractual provisions outside the EU market. A depositary association understood that the steps foreseen for the third party are not direct obligations and the performance of such requirements may be provided for in the contractual arrangements between the third party and the depositary. Similarly, two asset management associations pointed out that the UCITS Directive itself is not directly applicable to delegates and hence it cannot create direct obligations for them.

21. Two respondents claimed that the requirements under paragraph 19 of the consultation paper would be difficult to implement.
22. Some respondents suggested that obtaining legal advice from independent legal counsel should be recommended but not prescribed and that – depending on the circumstances – the assessment of the depositary’s internal legal services may be an alternative.
23. Three respondents were of the view that the third party should be required to obtain independent legal advice first, except if the depositary decides to obtain itself independent legal advice. Similarly, a depositary mentioned that it is market practice for the depositary (or its global custodian) to procure the legal opinion. Some other respondents suggested that ESMA introduce further flexibility by setting out the steps to be taken and leave some discretion to the depositary to decide whether to carry out those steps itself or to have the third party carry them out. On the contrary, one respondent argued that it should not be required for the third party to obtain the legal opinion for the benefit of the depositary as the latter is ultimately liable for the restitution of assets.
24. The following specific comments were made on the part of the draft technical advice setting out the steps to be taken by the third party:
 - a) Paragraphs 1(a)(i) and 2(b)(i): the meaning of ‘independent’ should be defined;
 - b) Paragraph 1(b)(iv): the relevant requirements are unreasonable and go too far as it will be very difficult to comply with them in practice;
25. Two consumer representatives mentioned that the IOSCO Recommendations Regarding the Protection of Clients Assets to which ESMA refer to should be considered as a minimum standard and not as mere guidance.
26. The majority of respondents asked ESMA to clarify that if the third party to whom the depositary has delegated functions referred to in Article 22(5), in turn sub-delegates those functions, such sub-delegation is subject to the same requirements. While this was already the case by virtue of the last paragraph of Article 22a(3), it would be helpful for it to be included in the Level 2 measures, in line with the approach followed under the AIFMD (Article 98(4) of the AIFMD Level 2).

ESMA response: Given the broad support received from those respondents who replied to this question (in particular, from consumer representatives), ESMA decided not to change substantially its approach on the steps to be taken by the third party.

ESMA saw merit in the request to provide further clarity on the meaning of ‘independent’ and clarified that the legal advice should be received from a natural or legal person not affiliated to the third party.

ESMA also saw merit in clarifying that if the third party further sub-delegates the functions referred to in Article 22(5) of the UCITS Directive, the same requirements should apply through contractual arrangements (see the new paragraph 6 for this part of the advice).

On the comment relating to the fact that direct obligations may not be imposed on third parties, ESMA agrees that the relevant obligations may only be imposed through contractual arrangements. However, the advice still refers to requirements for the third party in order to mirror the provisions of Article 22a(3) of the UCITS Directive and the request for technical advice from the Commission.

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?

27. Consumer representatives pointed out that verifying the applicable insolvency regime may be difficult, but this should not lead to a detrimental outcome for the end investor who is very likely not to even be aware of the applicable insolvency regime.
28. An asset management association noted that legal advice will not provide the depositary or its third-party delegate with a clear legal opinion on the basis of which its “best efforts” can be “ensured” in the context of a local insolvency proceeding. To the extent that legal advice has not been tested in a court, it should not be a necessary requirement, but rather a means to prove the “good faith” of the parties in adhering to the relevant requirements of the UCITS Directive. Similarly, another asset management association argued that there is no need to obtain individual legal advice for each jurisdiction and for each delegate as in most cases generic information could be sufficient. The same respondent argued that legal advice could be counterproductive as it would take the responsibility from the depositary.
29. A large number of respondents pointed out that there are limits to the level of certainty of outcome that may be obtained in many markets, and that this depends on the complexity of the applicable insolvency regime and on how certain the legal advice is. A depositary association also flagged that some laws foresee use of third parties that do not necessarily segregate customer assets in all cases: it mentioned the US example (where commercial banks are subject to strict segregation rules, while broker-dealers operate on the basis that some assets falling above certain thresholds may not be readily identifiable and are secured pursuant to collateral requirements) and the example of the forthcoming Hong Kong-Shanghai Stock Connect Scheme (where it is uncertain whether underlying investors would see their ownership interest recognised by Chinese courts).

30. One respondent considered that the legal opinion requirement is a suitable way of determining whether insolvency law in the depositary country provides adequate protections, while warning about the substantial costs that this may imply.
31. Given the significant additional costs that would be triggered by having to require legal advice, an asset management association suggested allowing the depositary or the third party to first seek to leverage on existing advice (e.g. industry associations, ISDA legal opinion) before requesting an ad hoc opinion from a legal practitioner. The content of such legal opinions should be the same irrespective of whether it is originally obtained by the third party, the depositary or an industry association. Along the same lines, some other respondents suggested permitting the reliance on legal opinions centrally provided (e.g. by national authorities or industry associations). One of these respondents mentioned that ISDA provides its members with legal opinions on the enforceability of the termination, bilateral close-out netting and multibranch netting provisions of the 1992 and 2002 ISDA Master Agreements.
32. Two asset management associations recommended that it should be up to the depositary or the third party to ask for legal advice while exercising its prudence and discretion on a case-by-case basis. One of these two associations added that it would be disproportionate to ask for such advice in any non-EU jurisdictions as the degree of sophistication of their respective domestic laws and regulations on protecting client assets and the related insolvency laws vary.

ESMA response: Notwithstanding the difficulties and costs highlighted by several respondents, ESMA considered it appropriate to keep the requirement for the third party to obtain independent legal advice, in particular taking into account the support received from consumer representatives. In reaching this conclusion, ESMA also took into account that some respondents mentioned that many global custodians today as a matter of good practice obtain legal opinions from markets where they provide custody services (see the responses to Q6 below).

Regarding the suggestions from some stakeholders to rely on other sources of advice (such as industry associations), ESMA had doubts about whether such sources indeed existed and, in any case, how to reflect such a suggestion in a legal text.

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.

33. The majority of respondents (including asset managers, depositaries and their associations) noted that the increase in costs under the proposal could be substantial as the legal advice would be needed for any jurisdiction outside the EU where financial instruments are held in custody. Some of these respondents pointed out that costs might have to be ultimately borne by investors. An asset management association was of the view that there would be additional costs which may, or may not, be significant.

34. One respondent provided an approximate estimate of costs amounting to EUR 15,000 per piece of legal advice and per country, while some respondents pointed out that costs may vary within a jurisdiction and from country to country. Other respondents did not expect a significant increase in terms of costs that would be faced by the third party delegated entities.
35. Two respondents mentioned that many global custodians today as a matter of good practice obtain legal opinions from markets where they provide custody services. One of these respondents added that such legal advice may in some circumstances require additional input to address specific questions on insolvency and/or jurisprudence and this could increase costs.
36. Two consumer representatives argued that the decision to use a sub-custodian outside the EU is made by the depositary and the investment company and, therefore, these entities should bear the costs of such a choice. A third consumer representative was of the view that it is part of good governance for a financial company handling financial instruments owned by other legal or physical persons to obtain qualified legal advice on the applicable insolvency regime.

ESMA response: See the response under Q5 above.

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

37. The large majority of respondents did not recommend any further steps. In particular, some of these respondents referred to the ongoing nature of the obligation of the third party by virtue of paragraph 1(a)(iii) of the draft advice.
38. One respondent suggested requiring the third party to inform the depositary in case there are changes in the regulatory framework.
39. Two consumer representatives mentioned that the third party should be required to ensure that all standards applicable to the third party are maintained by any sub-delegate further down the chain.

ESMA response: Given the feedback received, ESMA decided not to provide for any further steps.

On the comment made by the consumer representatives for the case of further sub-delegation in the custody chain, ESMA considers that the issue is addressed by the provisions of the new paragraph 6 of this part of the advice.

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?

40. Most respondents did not suggest any additional provisions. The main argument that was made is that, in case of sub-delegation by a sub-custodian to another third party, the requirements apply *mutatis mutandis* to all the relevant parties of the custody chain (Article 22a(3) of the UCITS Directive). However, several respondents suggested clarifying that in case of sub-delegation the same requirements would apply (see also the comments made by several respondents under Q4 above).
41. One respondent was of the opinion that the depositary should contractually be required to be informed in advance when the sub-custodian plans to further sub-delegate its function and that it should have some access to the effective custodian in order to avoid any deterioration in the custody chain. Two other respondents mentioned that any sub-delegation should require the prior written consent of the depositary and must be subject to the same conditions agreed and practiced between the depositary and the third party.
42. Consumer representatives argued that any further sub-delegation should be forbidden for UCITS funds sold to individual investors and asked ESMA to require at least that such a sub-delegation should be duly justified and documented.
43. Two respondents asked ESMA to re-affirm the provisions of recital 22 of the UCITS Directive according to which a third party to which the safekeeping of assets is delegated should be able to maintain an omnibus account as a common segregated account for multiple UCITS. One of these respondents added that UCITS assets can be held together with assets belonging to other clients of the sub-custodian.

ESMA response: Given the feedback received, ESMA decided not to give any specific consideration to the scenario where the third party further sub-delegates the safe-keeping of assets, other than clarifying that, in this case, equivalent requirements apply *mutatis mutandis*, in line with the provisions of Article 22a(3), last sub-paragraph of the UCITS Directive (see the response under Q4 above).

On the request relating to omnibus accounts, ESMA considered that this went beyond the scope of the request received to provide technical advice.

Measures to be put in place by the depositary

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

44. A few respondents disagreed with the identified steps arguing, *inter alia*, the following:
 - a) it is extremely difficult to become familiar with all of the relevant regulations of all markets;
 - b) the third party should be required to obtain independent legal advice, except if the depositary decides to obtain it itself.
45. Several other respondents (including consumer representatives) agreed with the proposed steps.

46. Two other respondents made the following remarks:

- a) they suggested not to exaggerate due diligence requirements; in particular, they objected to the requirements under paragraph 30 of the consultation paper;
- b) they expressed reservations on whether the delegated acts may impose obligations on the depositary as the Level 1 provisions are addressed to the third party (Article 22a(3)(d) of the UCITS Directive).

47. The following specific comments were made on the part of the draft technical advice setting out the steps to be taken by the depositary:

a) Paragraph 2(a):

- the need for these provisions was questioned as some due diligence requirements are likely to be covered in the Commission’s delegated acts on other aspects of UCITS V;

b) Paragraph 2(b)(ii):

- a request to delete these provisions was made as the foreseen termination of the agreement does not provide for a solution and would sever the contractual relationship between the depositary and the third party;
- it was argued that “immediate” termination of contracts with third parties is not market standard: typically, assets cannot be moved from one third party to another immediately;
- a request was made to provide guidance on what constitutes an insolvency event and to suggest language for the contractual termination provisions to be inserted in the delegation arrangements;

c) Paragraph 2(b)(iii):

- the depositary should not remain strictly liable once it becomes aware of the change of the applicable insolvency laws and jurisprudence and notifies both the UCITS/its management company and the competent authority;
- the wording should be amended in order to say “[...] *shall not change the legal nature of the assets [...]*”.

d) Paragraphs 3 and 4:

- Two consumer representatives suggested clarifying (i) whether there should not be an ultimate obligation for one party to provide independent legal advice and (ii) what would happen in case two conflicting pieces of legal advice were received by the depositary and the third party (in particular, in terms of consequences on the liability regime).

48. Three respondents welcomed the principles-based approach followed in the draft advice (as opposed to a template or a list of tasks to perform).
49. An asset management association suggested the following further “reasonable efforts” when appointing a third party outside the EU:
- a) The management/investment company, together with the depositary, should assess the extent of the risks and outline steps to mitigate them;
 - b) The management/investment company, together with the depositary, should communicate the outcome of the above assessment to the competent authority of the UCITS for an action plan to be agreed;
 - c) The relevant steps and consequences should be adequately outlined in the fund’s prospectus so as to be better aware of potential risks at sub-custody level.
50. Several other respondents suggested also including the additional measures referred to under paragraph 18(a) and (b) above.

ESMA response: Given the broad support received from respondents, ESMA did not introduce any substantive amendments to this part of the advice.

On the specific suggestions made, ESMA decided to do the following:

- To amend paragraph 2(b)(ii) to clarify that the contractual provisions should ensure the termination of the agreement without undue delay “*taking into account the need to act in the best interest of the UCITS and the investors of the UCITS*”. Moreover, ESMA wishes to clarify that the requirement is for the contract with the third party to include provisions allowing the termination without undue delay (i.e. the advice itself does not impose immediate termination).
- To add the clarification requested on paragraph 2(b)(iii) of the advice (i.e. “[...] shall not change the legal nature of the assets [...]”).
- To add a new paragraph 3 specifying the notification and measures that would be expected from the management company/investment company.

On the comments made by consumer representatives on paragraphs 3 and 4 of the draft advice, ESMA considers that the advice provides for an obligation on each of the two parties (the depositary and the third party) to obtain independent legal advice, unless a suitable advice is obtained by any of these two parties in line with the requirements of paragraphs 4 and 5 of the final advice. In case conflicting sets of advice are received by the two parties, ESMA considers that, depending on the circumstances, this may be an indicator that it is not ensured that in the event of insolvency of the third party, assets of a UCITS held by this third party in custody are unavailable for distribution among or realisation for the benefit of creditors of the third party.

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.

51. Two respondents highlighted the difficulties in quantifying both one-off and ongoing compliance costs for depositaries. Another respondent mentioned that costs will be incurred, but it is not possible to obtain accurate data because this will depend on the granularity of the requirements.
52. A large number of respondents mentioned that there will be significant additional costs for depositaries. The following types of cost were mentioned:
- a) costs linked to the review and change of contracts between the depositary and the third party and between the third party and any entity to which it delegates custody;
 - b) legal, operational and resourcing costs (e.g. legal costs associated with redrafting existing sub-custodian agreements and drafting new agreements for newly appointed sub-custodians);
 - c) additional and specialised resources to ensure the depositary's ongoing compliance with the requirements and to monitor sub-custodian's compliance with the requirements;
 - d) cost of obtaining independent legal advice by the depositary;
 - e) ongoing operational costs due to the required technology builds or adaptations and set-up and maintenance of additional accounts that may need to be opened or restructured in certain markets.
53. One depositary association did not expect significant one-off and ongoing compliance costs for depositaries in order to take the steps identified in the relevant part of the CP.

ESMA response: See the response under Q9 above.

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

54. A large number of respondents did not suggest any further steps, while certain stakeholders cross-referred to the additional steps that they suggested under Qs 3 and 9.
55. The following further steps were suggested:
- a) to insert appropriate clauses in the delegation contracts granting depositaries access to the books and records of the sub-custodians to monitor compliance in line with the UCITS Directive's requirements;
 - b) assessing the delegate's practices, procedures and internal controls, assessing whether the delegate's financial strength is consistent with the appointment and whether the delegate has the operational and technical expertise;

- c) requiring the delegate to perform a periodic review of the third party;
- d) requiring the depositary to have in place a contingency plan in relation to each jurisdiction in which it has appointed a delegate.

ESMA response: Given the feedback received, ESMA decided not to provide for any further steps. See also the responses under Qs 3 and 9.

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?

- 56. Several respondents referred to the measures that they proposed in their answers to Qs 3 and 9.
- 57. Other respondents suggested the following measures to be taken by the depositary:
 - a) disclosure to the UCITS management/investment company so that this aspect of custody risk can be taken into account in the investment decision;
 - b) to take such measures in the local jurisdiction to make the assets as “insolvency-proof” as possible and potentially based on local legal advice;
 - c) to undertake appropriate levels of ongoing monitoring to ensure that the relevant sub-custodian continues to comply with the criteria and requirements set out in the draft advice (which may involve an enhanced level of credit monitoring or frequent reconciliations to detect early warning signals of potential problems);
 - d) to notify the UCITS management/investment company when it becomes aware that segregation is not or no longer sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction: one of the respondents who suggested this measure indicated that the provision of the relevant information should not discharge the depositary from its responsibilities to the management/investment company;
 - e) in case the UCITS management/investment company does not provide guidance to the depositary nor agree to the transfer of the assets to an alternative third party in another jurisdiction, to notify the relevant competent authority and seek guidance;
 - f) possible termination of the contractual agreement with the sub-custodian; taking into account the situation of the sub-custodian and the fraction of assets under



management in the relevant jurisdiction, it may be in the best interests of investors not to terminate the agreement immediately.

58. One respondent noted that recital 118 of the AIFMD Level 2 states that, in the event that the legislation of the country does not recognise the effects of an appropriately implemented segregation, this should be classified as an external event beyond the reasonable control of the depositary, which would consequently be free from liability for their custody.
59. Several respondents mentioned that transferring the assets to another country presupposes that it is possible for the assets to be safe-kept in another country, which is not always the case. Some of these respondents argued that if the transfer of assets was not a viable option, then the management company would be forced to sell the assets, which would not necessarily be in the best interests of the investors. Another group of respondents was of the view that the transfer of assets is unlikely to be possible at all in many cases since sub-custodians are often used in order to access CSDs from which securities entitlements emanate (i.e. only local sub-custodians can be members of a local CSD).
60. On the contrary, two respondents (including a consumer representative) agreed that the transfer of the assets held in a non-EU jurisdiction to another (EU or non-EU) jurisdiction which recognises the segregation of assets in the event of insolvency is in the best interests of the investors. Two other respondents considered this possibility acceptable, but stressed that the depositary should have scope to take the most appropriate decision (e.g. an alternative could be the return of the UCITS assets to the depositary in instances where the segregation of the UCITS assets can no longer be guaranteed).
61. Two consumer associations mentioned the risks inherent to a long custody chain and the fact that it is essential to UCITS' clients that the chain of depositaries be kept as short as possible.

ESMA response: In light of the feedback received, and in particular the issues that were highlighted on the practicability of moving the assets to other jurisdictions, ESMA decided to keep the provisions of paragraph 2(b)(iii) and not to impose any additional requirements other than those set out in the new paragraph 3 (for further explanation on this new paragraph see the responses to Qs 3 and 9).

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

Conditions and criteria for the management company/investment company and the depositary to act independently

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

62. Several respondents (including consumer representatives) agreed on the identified links. In particular, one respondent pointed out that high profile frauds such as Madoff may



have been prevented if independence had existed between the management company and the depositary.

63. Another group of respondents disagreed that the links identified in the draft advice may jeopardise the independence of the Relevant Entities.
64. On common management/supervision, several respondents agreed that this may to a certain extent interfere with the independence of the Relevant Entities.
65. On cross-shareholdings, the majority of respondents argued that the Level 1 of the UCITS Directive requires that the Relevant Entities “act independently” of each other, as opposed to any provision that may call for their full “structural” or legal separation. Some of these respondents added that letter (g) under option 2 also goes beyond the Level 1 provisions for the same reasons. Other respondents suggested that the focus of the ESMA advice should be on conduct rules (including possible sanctions), aimed at identifying, managing and disclosing eventual conflicts of interest to investors. A depositary association added that a common shareholding of a depositary and fund manager should not be presumed to undermine the functional independence of the two functions.
66. Some respondents specifically disagreed that the independence of the Relevant Entities is jeopardised by any cross-shareholding. They argued, inter alia, that these entities are heavily regulated with strict responsibilities and obligations, under the supervision of their relevant competent authorities.
67. Several respondents urged ESMA to consider the orientation of IOSCO on the matter of ensuring adequate separation in the activities of the Relevant Entities (see the Consultation Report on Principles regarding the Custody of Collective Investment Schemes’ Assets published on 10 October 2014)¹. In particular, draft Principle 4 in the IOSCO document foresees that the “custodian should be functionally independent from the responsible entity”, thereby suggesting that the custodian ensures its independence in the way it carries out its obligations.
68. Some other respondents recalled the following additional elements:
 - a) the absence of evidenced market failure (in particular, objecting to any analogy with the links identified in the Madoff fraud);
 - b) the fact that depositaries are required to have in place and implement strict and detailed internal procedures for the prevention of conflicts of interest;
 - c) for depositaries subject to MiFID, reporting obligations include specific reporting on the safekeeping of assets performed by an independent law firm on an annual basis;

¹ Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD454.pdf>.

- d) the new depositary regulatory framework (in particular, the UCITS strict liability regime for depositaries) which will provide investors with a greater level of protection.

ESMA response: Notwithstanding the fact that some criticism was expressed by a large number of respondents on the possible approaches envisaged on cross-shareholdings, ESMA considered that the links identified in the CP were the right ones and decided not to modify its overall approach. See the responses below on how the specific comments referred to above were addressed.

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.

69. The large majority of respondents did not consider that any additional links should be taken into account.
70. Several respondents argued that the functional independence of the Relevant Entities is best served through the consistent implementation of the UCITS Directive's own conflict of interests rules. They added that it is unlikely that a regulation would be able to identify an exhaustive list of all cases.
71. Some respondents (including consumer representatives) mentioned that a contractual commitment (e.g. the provision of other services provided by the depositary to the management company) or other relationship could impact the independence of the Relevant Entities. Some of these respondents suggested considering the following requirements:
 - a) To discuss the relevant commitment/relationship with the relevant competent authority/ESMA;
 - b) To consider these links under the relevant policies on conflicts of interest with both Relevant Entities being required to agree on whether these links jeopardise the independence of either party. In case of disagreement the link should be discussed with the relevant competent authority/ESMA.

ESMA response: Given the feedback received and the lack of precise suggestions on how to tackle contractual commitments or other relationship, ESMA decided to only refer to the already previously identified links in its final advice.

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?

72. Several respondents (including consumer representatives) considered that the presence of any of the identified links could be sufficient to jeopardise independence and, therefore, objected to the idea of setting out a cumulative test.

73. Several asset managers and depositaries (and their associations) agreed that common management/supervision may, to a certain extent, interfere with the independence of the Relevant Entities, but considered that cross-shareholdings/group inclusion cannot pre-determine a lack of independence of the Relevant Entities.
74. Three respondents considered that cross-shareholdings/group inclusion links should not be included as they cannot pre-determine a lack of independence of the Relevant Entities. Similarly, two other respondents opposed the ban on cross-shareholdings/inclusion in the same group.
75. One respondent was of the view that only the cumulative presence of all the identified links would jeopardise the independence of the Relevant Entities.
76. Some respondents considered that the links identified are not liable to jeopardise the independence of the Relevant Entities.

ESMA response: Given the feedback received, ESMA maintained its initial proposal according to which the presence of any of the identified links would be sufficient to jeopardise independence.

a) Common management/supervision

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?

77. The large majority of respondents agreed with the ESMA proposal.
78. Some respondents stressed the importance of not adding additional requirements at national level.
79. Other respondents suggested that ESMA should avoid fixing any percentage which could contrast with other provisions on corporate governance (e.g. Article 91(4) of CRD IV). Another respondent suggested a less stringent approach according to which no more than half of the members of the management body of the management/investment company would be members of the management body of the depositary. An asset manager disagreed with the prohibition for any members of the management body of one of the Relevant Entities from also being an employee of the other Relevant Entity.
80. Two respondents argued that the body in charge of the supervisory function (in companies with a dual structure) should not be assimilated to the management body for the purpose of the relevant separation.
81. Two other respondents mentioned that in certain Member States (e.g. Germany) the composition of a supervisory board is subject to mandatory legal provisions e.g. employees must be represented in the supervisory board of their employer.

82. Two respondents suggested modifying the proposal to say that the management body of one of the Relevant Entities should not be predominantly composed of representatives from members of the management body or employees of the other Relevant Entity.
83. Some respondents disagreed on the idea of providing indications as to the composition of the management body of the management/investment company and the depositary.
84. Three respondents advocated the removal of letters (c) and (d) of this part of the draft advice, as well as letter (g) under option 2. Moreover, as for letters (a) and (b) of this part of the draft advice, one of these respondents (an asset management association) advocated allowing executive members of the management body of one of the Relevant Entities to occupy non-executive functions within, or be employees of, the management body of the other Relevant Entity.
85. Three other respondents argued that properly-constructed internal organisational practices (functional and hierarchical separation) and rules on the management of conflicts of interest are adequate to address the relevant concern.

ESMA response: Considering the broad support received (including from consumer representatives) on the approach taken and the limited feedback received on the restructuring that the proposal would imply, ESMA decided to stick to its initial proposal and not to modify the proposal on common management/supervision.

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.

86. Several respondents disagreed, arguing that functional and hierarchical separation measures should be sufficient, but the majority of respondents (including consumer representatives) considered the cap appropriate.
87. Some respondents noted that it is not common in the UK to have two separate bodies, as UK incorporated companies have unitary boards.
88. An asset management association asked for clarification on the definition of 'management body' by limiting it to those members with executive functions.
89. One respondent suggested an alternative percentage of one tenth.

ESMA response: See the response to Q16.

As to the request to clarify the definition of 'management body', the relevant definition is already provided in Article 2(1)(s) of the UCITS Directive and ESMA considered that even non-executive members may exercise influence which may jeopardise independence.

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.

90. Several respondents mentioned the difficulty of providing data and costs estimates.
91. Several other respondents mentioned that costs would be incurred and would be linked, inter alia, to the need to – at a minimum – appoint new personnel and remove existing personnel. One respondent reported having one UCITS management company within the group for which the supervisory board should be restructured to comply with the one third rule.
92. A number of respondents mentioned that, compared to the rules proposed on the cross-shareholdings/group inclusion, the proposal on common management/supervision is likely to lead to limited additional costs. One asset manager did not have knowledge of any restructuring needed.
93. Two respondents mentioned that the Spanish law prohibits common directors or managers; therefore, the proposal should not entail any restructuring. Some other respondents were not aware of instances where restructuring would be required in the UK, given the current national requirements.

b) Cross-shareholdings/group inclusion

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

94. Some respondents (including consumer representatives) favoured option 1. Two other respondents did not object to this option. Another respondent was of the view that this option would provide the highest level of investor protection, while mentioning that its costs could potentially outweigh the benefits.
95. Consumer representatives argued that option 1 provides for the clearest and most straightforward way to address the issue of conflicts of interest and would ensure the highest standard of investor protection and corporate governance. They also added some considerations on the mapping exercise conducted by ESMA.
96. An academic argued that option 1 appears to be an effective and objective solution for avoiding conflicts of interest. Given the legal and economic interests at stake, in particular the defence of the interests of retail investors, this option is balanced.
97. The following amendments were suggested by certain respondents supporting (or not objecting to) option 1:
- a) shareholding level of 15% rather than 10%;

- b) deletion of letter (e) as it is unnecessary since this option ensures independence through prohibition.

98. The majority of respondents objected to option 1. They raised, inter alia, the following arguments:

- a) The principle of proportionality is intended to ensure that regulatory measures go no further than is required to achieve a set objective, which is to ensure that the Relevant Entities have safeguards against conflicts of interest to allow for the independent performance of their activities;
- b) Option 1 goes beyond the provisions of Level 1. In some smaller jurisdictions like Sweden, depositaries will have to reconsider their business models and whether to continue as depositaries if they are denied the ability to provide services to certain funds. If the co-legislators had wished to prohibit the current model, they would have made this explicit in the Level 1 text;
- c) This option is likely to lead to an increase in systemic risk triggered by an accelerated concentration process in the depositary/custody business;
- d) There is a lack of evidenced market failure: events such as the Madoff scandal were not connected to circumstances where the asset management companies and depositaries belonged to the same group;
- e) Depositaries have the obligation to implement strict and detailed internal procedures for the prevention of conflicts of interest;
- f) The 10% limit to the cross-shareholdings is unjustified;
- g) A strong integration of process is necessary to reach the degree of automation which is necessary for the relation with the depositary: this is easier to achieve when parties belong to the same group.

99. The large majority of respondents preferred option 2 (or a revised version of it).

100. An asset management association was of the view that option 2 provided for a more balanced and proportionate approach to ensuring the Relevant Entities act independently by emphasising the importance of managing conflicts of interest and that these be disclosed (e.g. by disclosing the relevant composition of the boards as well as of the cross-shareholdings).

101. Several suggestions were made for amendments to option 2.

102. The suggestions made by respondents who preferred option 2 were as follows:

- a) letter (f):
 - the words “at least” should be deleted;

- the second part of this letter should be deleted;

b) letter (g):

- it should be deleted as, inter alia, excessive and not in line with the functional approach stated in the Level 1 and the IOSCO proposal at global level;
- the requirement is excessive and should be revised;
- the required number of independent members should be lowered to a quarter.

103. The suggestions made by respondents who preferred (or did not object to) option 1 were as follows:

a) letter (e):

- the word “exclusive” should be replaced by “sole” for consistency with Article 25(2) of Level 1;
- it should be stated that the management company is not obliged to appoint a depositary to which it is linked.

b) In case a particular conflict could not be effectively managed, it should be avoided (mere disclosure to investors would be insufficient). The Relevant Entity should notify the relevant competent authority of the situation, the specific identified conflicts and the steps it has/is taking to manage those conflicts effectively and to ensure that the conflicts do not prevent it from carrying out its functions in accordance with Article 25(2) of the UCITS Directive.

c) The relevant competent authority should take action in case it is not satisfied that the steps taken effectively manage the relevant conflicts.

d) Verification of compliance with the policies for managing conflicts of interest should be attributed to independent units (in any case, not integrated into structures or functions designed to group level) The findings of the control tasks performed by these independent units should be raised to the board of directors of the management company and, at least annually, to the competent national authority.

e) In the event that the reports prepared by the independent units revealed significant exceptions in compliance with the conflict of interest policies, consideration should be given to forcing the replacement of the depositary with one that is not part of the same group.

f) In case a Relevant Entity is obliged to appoint a depositary from within the group, it should notify this to its competent authority and demonstrate that it is satisfied that this is in the sole interest of investors in the UCITS. It should also be required to periodically review the appointment and the costs of using a group depositary versus a non-group depositary.

- g) Depository appointment should always be justified, regardless of whether it is requested or not by investors.
- h) The type of link, if any, between the management company and the depository should be published in the information documents aimed at the market and investors.
- i) The concept of independent director should be in line with that in other fields (especially with that developed in the field of studies on corporate governance) in order to strengthen their role as defenders of the interests of investors.

104. A banking association preferred neither option 1 nor option 2.

105. One respondent mentioned that some Spanish credit institutions made the decision to separate their depository activities and would thus not be effected by either of the options.

106. Several respondents considered it important that the Level 2 measures on independence be applied in the same way throughout the EU and that all competent authorities apply the same requirements and do not impose additional requirements on local UCITS.

ESMA response: Notwithstanding the fact that strong arguments were made for structural independence (i.e. option 1), ESMA recognises that such an option might imply important restructuring and other costs for the industry in many European jurisdictions. Therefore, ESMA followed option 2 in its final advice while recognising that robust safeguards are needed in the context of this option in order to reflect the balance of feedback, particularly from consumer representatives.

To this extent, ESMA saw merit in introducing the following amendments to option 2, along the lines of some of the suggestions made by respondents:

- the management company/investment company shall demonstrate to its competent authority that it is satisfied that the appointment of the depository is in the sole interests of the UCITS and the investors of the UCITS, in particular by comparing the relative merits of appointing the depository versus another depository which is not linked to the management company/investment company;
- the link between the management company/investment company and the depository shall be disclosed to investors.

Moreover, the requirement to have some independent members within the management body/supervisory function has been kept. On the specific issue of the number of independent members, ESMA considered that requiring only one independent member – as favoured by several respondents – is likely to make it very difficult for that individual to influence the board discussions in any meaningful way. However, ESMA recognises at the same time that, depending on the number of members of a given management body/supervisory function, one third may be excessive. Therefore, ESMA saw merit in

providing an alternative minimum of two members and to leave the possibility to choose between one third or two, whichever is the lesser.

Finally, ESMA recognises that, while the obligation to “act independently” may be fulfilled through a series of measures ensuring functional independence between the parties, it is also possible to achieve this outcome through the structural independence of the parties (i.e. in line with option 1).

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.

107. Consumer representatives mentioned that, if option 2 were to be chosen, this should be the minimum requirement. Some other respondents (including an investor association) also supported the proposed cap.
108. A law firm was of the opinion that it would seem sensible to require more than half of the members of the management body to be independent, while at the same time recognising that this may have an impact on some groups that is disproportionate to the benefit to investors.
109. The majority of respondents disagreed with the proposed minimum number of independent members of the management body, although some of them supported the requirement that some members be independent.
110. Some respondents considered that governance issues should not be tackled in the context of the requirement for the management company and the depositary to act independently. Some other respondents mentioned that general measures to prevent conflicts of interest are sufficient. Similarly, other respondents considered that the requirements on common management/supervision, together with robust management of conflicts, should be sufficient to ensure independence. The requirement to appoint additional independent directors is likely to increase costs, which may ultimately be borne by investors and there might be an issue in terms of scarcity of appropriately qualified persons.
111. Some respondents requested that ESMA introduce a principle of proportionality in relation to this requirement.
112. Several respondents suggested limiting the number of independent directors to one or two. A depositary recommended lowering the required number of independent members from a third to a quarter. Another respondent suggested introducing a minimum requirement of 10% of the members.
113. An asset management association suggested the following:

- a) allowing the cumulative presence in the management bodies of the Relevant Entities for those members without executive powers;
- b) allowing an independent director in one company to hold the same position in another company of the group: in this context, this respondent referred to the definition of 'independent director' in the Commission Recommendation 2005/162/EC.

ESMA response: Please see the response to Q19. ESMA also saw merit in the proposal to refer to the definition of 'independent director' in the Commission Recommendation 2005/162/EC and decided to introduce some elements of such definition in the notion of independent members which is relevant for the purpose of paragraph 1(g) of the advice.

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

114. A large number of respondents (including consumer representatives) agreed with the proposed approach on the concept of independence.
115. The majority of respondents disagreed with the proposal. Two of these respondents noted that directors are legally bound to solely act in the interest of the single company they represent and have to comply with the respective rules governing conflicts of interest, regardless of whether they serve as independent directors on boards of other entities within the same group. Two asset management associations added that members of the management body and employees that are functionally and hierarchically separated from the management/investment company and depositary function should not be excluded from the concept of independence.
116. Several respondents considered that the concept of independence should not include members of the management body nor employees of undertakings of the group, provided the undertakings are not the depositary, the management/investment company or their affiliates.

ESMA response: Please see the responses to Q19 and 20.

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.

117. An asset management association pointed out that data and costs estimates implied by the choice of the envisaged policy options are difficult, if not impossible, to obtain and this is further complicated by the very tight deadline granted for the consultation.
118. The majority of respondents argued that option 1 would entail relevant costs that would ultimately be borne by UCITS investors. Two respondents also mentioned the issue of the lack of sufficient time for implementation prior to March 2016, unless a suitable transitional period is granted.

119. Some respondents argued that option 1 would contradict the freedom of enterprise and lead to a far-reaching market restructuring detrimental to:

- a) employment in the financing sector,
- b) the financing of the economy,
- c) the stability and safety of the whole UCITS model and so to investors, and
- d) the stability of the banking sector.

120. Another group of respondents mentioned the following consequences:

- a) financial groups with a depositary arm will be compelled to limit their operations in asset management, thus depriving the market of a substantial part of the range of products available for investment for the retail market; and
- b) financial groups with an asset management arm will exit the depositary sector.

121. Respondents mentioned the following one-off costs in relation to this option:

- a) upfront costs for appointing new and external depositaries to service entire ranges of funds;
- b) change in ownership structures of business groups;
- c) consultancy charges;
- d) tax advisory fees;
- e) management's time across all concerned entities;
- f) transition costs linked to IT and for the overhaul of data sharing protocols;
- g) legal costs, including for renegotiation of depositary agreements, prospectus changes and constitutional document changes and any translation costs;
- h) regulatory approvals costs – a change of management company or depositary for UCITS requires regulatory approval and also may require cross-border notifications;
- i) investor notification – in many jurisdictions such a change requires notification to all shareholders;
- j) transaction and associated costs for transition to the new provider of UCITS financial instruments held in custody, for certain other assets and for other assets not held in custody if recorded or maintained in the depositary's books and records;
- k) establishment of new cash accounts and associated cash linkages through the new custodian's correspondents;

- l) renegotiation of counterparty and (if relevant) prime brokerage agreements, which will be more extensive where the counterparty or prime broker has been appointed as sub-custodian for assets of the UCITS held as collateral or otherwise;
 - m) renegotiation of ISDA agreements - in some jurisdictions both the depositary and management company are parties to the ISDA;
 - n) depositary transition - it is not uncommon for an audit to be performed at the point of transition so that the new depositary is confident that the fund has been appropriately managed in the past;
 - o) costs incurred by the depositary for receipt of legal advice, management time and project management. This would include a full review of the assets, potentially performing due diligence on the management company, due diligence of the UCITS' investments, etc.
122. An asset management association mentioned that option 1 would entail losses linked to the 'fire sale' of shares (for Relevant Entities having cross-shareholdings) and business activities (for Relevant Entities belonging to the same group).
123. This respondent provided a rough estimate of the costs arising from option 1: these were estimated to range between EUR 80,000 (for a small member) to EUR 2,100,000 (for a large member). In case a transfer of the affected UCITS assets to an alternative depositary was considered, this respondent mentioned that the costs lined to that transfer would range between EUR 150,000 (for a small member) to tens of millions of EUR (for a large member). In terms of loss of earnings on the side of the substituted depositary, these could, in case of a large member, amount to up to EUR 30,000,000.
124. Another respondent reported having one UCITS management company within the group fully (directly/indirectly) owned by the depositary bank, being the biggest bank in Hungary.
125. The following estimations were provided by respondents in terms of impact on existing structures under option 1:
- a) Assets under Management (AuM):
 - France: 62% of AuM;
 - Luxembourg: 30.66% of AuM, equally to EUR 755 billion;
 - Italy: 9% of AuM;
 - Spain: various figures were provided: 65%, 67% and 70% of AuM;
 - Germany: 40% of AuM, equally to EUR 476 billion;
 - Finland: 25%.

b) Number of UCITS

- Luxembourg: 39.54%;
- Spain: 4,000 UCITS;
- Germany: some 2,600 funds with assets in total of EUR 476 billion.

c) Number of entities

- Luxembourg: 39 management companies and 32 depositaries;
- Spain: 35 fund managers and 39 depositaries;
- Portugal: more than 70% of the Portuguese management companies have either a common parent undertaking or a cross-shareholding;
- Germany: around 26 management/investment companies.

126. Three respondents were of the view that option 1 would have little impact in the UK given the current UK regulatory requirements.

127. Some respondents mentioned that a related effect of option 1 would be the gradual withdrawal of smaller, affiliated custody banks and the subsequent consolidation would inevitably benefit larger groups. A depositary association was of the view that capacity constraints or the lack of willingness by new providers to take on business due to its complexity or internal controls may give rise to situations in which some UCITS will not be able to find a new provider (whether a depositary or a management company).

128. According to three asset management associations, ongoing costs are expected to come from the loss of economies available through the use of common infrastructure, from access and understanding of new systems, as well as from a time-consuming need to identify and reappoint responsible persons.

129. Some respondents (including asset management associations) argued that option 2 would also lead to costs, but significantly lower than those implied by option 1. Three other respondents mentioned that the costs linked to this option would be the ones relating to the setting-up of alternative organisational arrangements, including compensation for members of the management/supervisory board which would need to be substituted. One respondent mentioned that the costs for this option would mainly be related to the implementation of procedures concerning the identification, management, monitoring and disclosure of conflicts of interest. Two banking associations pointed out that the requirement to have a certain number of independent directors may mean that a bank will have to have a representative from one of its competitors and may be problematic as a limitation of external mandates may apply at the top of the organisations.

130. An asset management association did not foresee any major impact arising from option 2 in Sweden since corresponding rules are already in place there.



ESMA response: Please see the response to Q19.

IV. Cost-benefit analysis

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

131. The very large majority of respondents (including consumer representatives) agreed with ESMA's proposal to discard the second and third options described under paragraph 47 of the consultation paper.
132. One respondent broadly agreed with all the three options and considered that options 2 and 3 should not be discarded altogether.
133. Three respondents agreed with the approach of discarding the third option, while disagreeing with the idea of discarding the second one. One of these respondents pointed out that the second option could be agreeable if the relevant quotas were amended.
134. Three other respondents disagreed with ESMA's approach.

ESMA response: Given the broad support received from those respondents who replied to this question, ESMA decided not to change its approach.



3 Annexes

3.1 Annex I – Commission mandate to provide technical advice

Mr Steven Maijoor
Chairman
European Securities and Markets Authority
103 rue de Grenelle
75007 Paris
France

Subject: Provisional request to ESMA for technical advice on delegated acts required by the UCITS V Directive

Dear Mr. Maijoor,

The services of the European Commission request the advice of ESMA on two implementing measures covering UCITS depositaries that are required by the soon-to-be-adopted Directive amending UCITS Directive ('UCITS V'). Most of the substantive rules and delegated acts in UCITS V are identical to those contained in the AIFMD. The present request therefore focuses on two empowerments not present in the AIFMD: (1) insolvency protection of UCITS assets when custody of those assets is delegated to third parties and (2) the independence of the UCITS depositary.

The present request for advice is based on the text adopted by the European Parliament at its plenary session on 15 April 2014 [T7-0355/2014]. While the Commission's services do not anticipate further changes in substance, the process of legal revision may result in drafting amendments and, as the case may be, the renumbering of articles. The Commission's services will keep ESMA fully informed of any such developments.

It is the Commission's established practice to adopt the delegated acts well before the end of the transition period. This would allow Member States sufficient time for transposition of the directive itself. Taking into account that Member States are obliged to transpose UCITS V not later than 18 months after entry into force, the Commission's services therefore request ESMA to deliver its advice by **15 October 2014**. An indicative timetable of all procedural steps is attached in Annex II.

In accordance with the principles of Better Regulation, the Commission, in preparing its delegated acts, is required to prepare a detailed **impact assessment**. As well as providing advice on the content of the delegated acts, ESMA is therefore requested to underpin its advice by first identifying a range of policy options and then undertaking an assessment of the costs and benefits of each option. The results of this assessment should be submitted alongside the advice.

The **technical advice** provided by ESMA to the Commission should not take the form of a legal text. However, ESMA should provide the Commission with a structured text accompanied by detailed explanations for the advice given.



The services of the Commission will, after transmission to ESMA, publish this provisional request for advice and any updated versions on the DG Internal Market and Services website.

Yours sincerely,

Jonathan FAULL

Contact: Rostislav Rozsypal, Telephone: +32 2 29 99431,
rostislav.rozsypal@ec.europa.eu

c.c.: O. Guersent, P. Dejmek, B. Dumont (Cab), C. Hughes (COMM), P. Pearson, MARKET List G4

Annex I: Empowerments for Level 2 measures to be elaborated by ESMA

1. Insolvency protection of UCITS assets when delegating safekeeping

Article 22a(3) requires, inter alia, that the third party to which custody of UCITS assets has been delegated " (e) takes all necessary steps to ensure that in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among or realisation for the benefit of creditors of the third party".

Article 26b empowers the Commission to adopt delegated acts specifying, among others: "(e) the steps to be taken by the third party pursuant to point (e) of Article 22a(3)".

ESMA is requested to advise the Commission on what necessary steps should be taken to ensure that in the event of insolvency of the third party, assets of a UCITS held in custody by the third party are unavailable for distribution among or realisation for the benefit of creditors of the third party.

ESMA is requested to specify those steps in the form of a non-exhaustive list of the measures, arrangements and tasks that the third party to which custody is delegated should put in place and perform on on-going basis in order to ensure that the UCITS assets are protected from distribution among or realisation for the benefit of creditors of the third party. These measures, arrangements and tasks must take into account the legal framework of the country in which the third party operates, notably that country's insolvency laws and relevant jurisprudence.

ESMA is also requested to specify the measures that the depositary should put in place ex-ante to ensure that the third party fulfils its obligations and how the depositary should ensure that the required level of protection is respected all the times.

2. Independence requirement

Second sub-paragraph of Article 25(2) requires that "*In carrying out their respective functions, the management company and the depositary shall act honestly, fairly, professionally, independently and solely in the interest 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 interest of the investors of the UCITS.*"

Article 26b empowers the Commission to adopt delegated acts specifying, among others: "(h) the conditions for fulfilling the independence requirement referred to in Article 25(2)."

ESMA is requested to advise the Commission on what are the necessary conditions and criteria, at a minimum in relation to areas such as corporate and group governance, structure, organisation and internal processes, so that each of the entities referred in Article 25(2) can be deemed to act independently in carrying out their respective functions.



Annex II: Indicative timetable for UCITS V Directive transposition and Level 2 work

Date	Milestones
Jun 2014	Request for advice
Jul 2014	
Aug 2014	
Sep 2014	UCITS V enters into force
Oct 2014	ESMA advice
Nov 2014	
Dec 2014	COM working documents: Draft L2 + IA
Jan 2014	ISC
Feb 2015	Translation
Mar 2015	Consultation with ESC
Apr 2015	Adoption of L2 measures
Jul 2015	End of period for EP and Council to object to Level 2 measures,
...	
Feb 2016	End of the transposition period of the UCITS V Directive

3.2 Annex II – Cost-benefit analysis

1. Introduction

1. On 3 July 2014, ESMA received a provisional request for advice from the Commission (see Annex II). The request relates to certain of the delegated acts foreseen under UCITS V. It recalls that in accordance with the principles of Better Regulation, in preparing its delegated acts, the Commission is required to prepare a detailed impact assessment. The Commission therefore asks ESMA to identify a range of policy options and then undertake an assessment of the costs and benefits of each option.
2. The delegated acts foreseen by UCITS V relate to the some of the new depositary provisions introduced by this Directive. The delegated acts covered by the request for advice are a subset of those which the Commission is empowered to adopt under UCITS V. Specifically, they are the ones relating to:
 - i) the necessary steps to be taken to ensure that in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among or realisation for the benefit of creditors of the third party (Article 22a(3) and 26b(e) UCITS V); and
 - ii) the conditions for fulfilling the independence requirement applying to the management company/investment company and the depositary (Article 25(2) and 26(b)(h) UCITS V).
3. Therefore, the draft cost-benefit analysis (Draft CBA) set out in the consultation paper (CP) published on 26 September was limited to the above-mentioned delegated acts for which the advice from ESMA was sought by the Commission. The present CBA (Final CBA) has the same scope, but has been updated to take into account the feedback received to the consultation.
4. As was the case for the Draft CBA, the Final CBA is mostly qualitative. However, the little quantitative data that was received during the consultation process has been incorporated into the relevant sections.

2. Identification of the necessary steps for the insolvency protection of UCITS assets when delegating safekeeping

5. The fact that assets of a UCITS held by a third party in custody are unavailable for distribution among or realisation for the benefit of creditors of the third party in case of insolvency of this third party is one of the key regulatory issues of UCITS V, because it is one of the main aspects of the investor protection framework put in place to learn from the Madoff experience, as well as one of the pillars upon which is based the possibility for UCITS to invest in a wide range of jurisdictions.
6. Therefore, the Commission asked ESMA to i) provide advice on the necessary steps to be taken in the form of a non-exhaustive list of the measures, arrangements and tasks that the third party to which custody is delegated should put in place and perform on

on-ongoing basis in order to ensure that the UCITS assets are protected from distribution among or realisation for the benefit of creditors of the third party, and ii) specify the measures that the depositary should put in place ex-ante to ensure that the third party fulfils its obligations.

Baseline scenario

7. The baseline scenario should therefore be understood for this cost-benefit analysis as the application of the requirements in the Level 1 Directive (i.e. the provisions of Article 22a(3) of UCITS V) without any further specification. This would leave discretion to UCITS management companies, depositaries and national competent authorities to determine the necessary steps that shall be taken to ensure that in the event of insolvency of a third party, assets of a UCITS held by the third party in custody are unavailable for distribution among or realisation for the benefit of creditors of the third party. This could clearly lead to a lack of harmonisation in the application of the provisions of the Level 1 UCITS Directive across the UCITS investment industry on a very sensitive issue.
8. Indeed, uncertainty on the above-mentioned steps considered as being necessary and on the measures to be taken by the depositary and third party could lead to a situation where some Member States would adopt stricter rules than others on these two issues, leading to greater uncertainty for investors of UCITS in the different Member States who would not know to what extent the assets of the UCITS they invest in are protected. For instance, a depositary could be considered as failing to meet the above-mentioned requirements in one Member State whereas the same depositary would be considered to meet these requirements in another Member State and therefore be allowed to safeguard the assets of a UCITS. This would be particularly problematic in the context of the EU passport of the UCITS Directive.

Technical option

9. The final technical advice aims to promote the objectives of the Level 1 Directive by clarifying the scope of application of certain of the UCITS V provisions. This should contribute to the creation of a level playing field across Member States, which will help ensure that the risks tackled by the UCITS management/ investment company are done so in a harmonised way and there is reduced scope for regulatory arbitrage which could hamper the key objectives of the Level 1 Directive.
10. In order to address the problem and comply with the objectives identified above, ESMA not only considered the idea of providing clarifications on the criteria which may be extracted from the Level 1 provisions, but also identified in the CP some topics for which additional guidance could be beneficial for the purposes of a harmonised application of the UCITS Directive. These topics were as follows:
 - i) ESMA developed a non-exhaustive list of measures, arrangements and tasks to be put in place and performed on an ongoing basis by the third party to which custody is delegated. In this regard, ESMA considered that segregation greatly supports the policy objective that UCITS assets would be unavailable for

distribution to the creditors of an insolvent third-party delegate of a depository. ESMA considered, therefore, that the basic requirement for the third party (which is located in a jurisdiction outside the Union) should be to make all reasonable efforts, including the receipt of independent legal advice, to verify that the applicable insolvency laws and jurisprudence recognise the segregation of the UCITS' assets from the third party's own assets and from the assets of the depository. In developing this part of the advice, ESMA took into specific account the recent Recommendations Regarding the Protection of Client Assets issued by IOSCO in January 2014.

- ii) ESMA also specified the measures that the depository should put in place ex-ante to ensure that the third party fulfils its obligations, and how the depository should ensure that the required level of protection is respected at all times. ESMA proposed to incorporate some of the above-mentioned IOSCO principles in the measures to be adopted ex-ante by the depository. Moreover, ESMA considered appropriate to require the depository to ensure that there are contractual provisions allowing the termination of the agreement with the third party in case the applicable insolvency laws and jurisprudence of a jurisdiction outside the European Union no longer guarantee the segregation of the UCITS assets in the event of insolvency of the third party or the conditions set out under these laws are no longer fulfilled.

11. In the light of this approach, ESMA decided to carry out a preliminary mapping of (i) existing provisions in this area in the different jurisdictions and (ii) the potential impact that the ESMA technical advice may have. Details on the outcome of the mapping were set out in the Draft CBA.

The likely economic impacts

12. On the basis of the mapping exercise, ESMA concluded that the impact of the final technical advice should not be material in most of the Member States. This was largely confirmed by the feedback to the consultation.

Costs

13. ESMA took the view in the Draft CBA that the proposed approach was unlikely to lead to significant additional costs to the extent that it provided clarifications on the Level 1 provisions and did not impose additional obligations beyond those already set by UCITS V on firms whose compliance has to be supervised, except the receipt of independent legal advice, that is required for the third party to which custody is delegated outside the Union and for the depository.

14. Regarding the requirement to obtain independent legal advice, many respondents to the consultation suggested that this would trigger significant additional costs and that, in any case, the level of legal certainty that could be obtained was limited. One respondent provided an approximate estimate of costs amounting to EUR 15,000 per legal advice and per country.

Benefits

15. In addition to the benefits of the option proposed in the CP as identified in the Draft CBA (i.e. to standardise the operational processes that the depositaries will set up to face such local rules applying to the custody of services and, as a consequence, to increase the protection of UCITS investors), several respondents to the consultation (including consumer representatives) stressed the importance of the depositary and third part obtaining legal advice that was not unduly influenced by commercial interests.

3. Identification of the conditions to be fulfilled by the management company/investment company to be considered independent

16. The independence of the management company/investment company and the depositary is one of the key regulatory issues of UCITS V, because it is one of the main aspects of the investor protection framework put in place to learn from the Madoff fraud.
17. Therefore, the Commission asked ESMA to provide advice on what are the necessary conditions and criteria, at a minimum in relation to areas such as corporate and group governance, structure, organisation and internal processes, so that each of the entities referred to in Article 25(2) (management company/investment company and the depositary) can be deemed to act independently in carrying out their respective functions.

Baseline scenario

18. The baseline scenario should therefore be understood for this cost-benefit analysis as the application of the requirements in the Level 1 Directive (i.e. the provisions of Articles 25(2) of UCITS V) without any further specification. This would leave discretion to UCITS management companies, depositaries and NCAs to assess whether UCITS management companies and depositaries act independently in carrying out their respective functions. This could clearly lead to a lack of harmonisation in the application of the provisions of the Level 1 UCITS Directive across the UCITS investment industry.

Technical options

19. The final technical advice aims to promote the objectives of the Level 1 Directive by clarifying the scope of application of certain of the UCITS V provisions. This should contribute to the creation of a level playing field across Member States, which will help ensure that the risks tackled by the UCITS management/ investment company / depositary are done so in a harmonised way and there is reduced scope for regulatory arbitrage which could hamper the key objectives of the Level 1 Directive.
20. In order to address the problem and comply with the objectives identified above, ESMA not only considered the idea of providing clarifications on the criteria which may be extracted from the Level 1 provisions, but also identified in the consultation paper

some topics for which additional guidance could be beneficial for the purposes of a harmonised application of the UCITS.

21. ESMA considered that the independence of the management company/investment company, on one side, and the depositary, on the other (together, the “Relevant Entities”), may be jeopardised by the existence of certain links between these parties, and that the following categories of links can be identified for these purposes:
 - a) common management/supervision; and
 - b) cross-shareholdings.
22. In relation to a) (common management/supervision), ESMA considered that the independence would be lost if any of the Relevant Entities, by means of executive power or supervision, could control the action of the other.
23. In the CP ESMA identified three options for how the separation of the management bodies of the Relevant Entities could be ensured. For a summary of the feedback from stakeholders on ESMA’s proposal to discard two of those three options, please see the response under Q23 in the feedback statement in section 2.
24. In relation to b) (cross-shareholdings), ESMA considered that a first option could be to refer to the notion of ‘qualifying holding’ in the UCITS Directive and consider that the Relevant Entities are not independent whenever they are linked by such a qualifying holding or are part of the same group. A second option could be to provide that in case the Relevant Entities are (i) linked by a qualifying holding or (ii) part of the same group, some specific governance and organisational arrangements and measures should be put in place to ensure that the independence of the Relevant Entities is preserved.
25. ESMA saw merit in consulting on both options to assess the impact that each of the proposed rules may have on the existing shareholding structures in Europe and make its final deliberations on this aspect on the basis of a full set of information.
26. ESMA also carried out a preliminary mapping of (i) existing provisions on the present topic in the different member States and (ii) the potential impact that the ESMA technical advice could have. Details on the outcome of the mapping were set out in the Draft CBA.

The likely economic impacts

27. On the basis of this feedback to the consultation, stakeholders found it difficult to assess the economic impacts arising from the proposed rules on common management/supervision while noting that the impact would be significantly lower than that triggered by the rules on cross-shareholdings. In some Member States the impact would be limited due to the existence of broadly similar rules.
28. As for the proposed rules on cross-shareholdings, the stakeholder feedback indicated that option 1 would have a much more significant impact than option 2.

Costs

29. Feedback from stakeholders on the common management/supervision proposals did not allow ESMA to quantify the likely costs.
30. Most respondents had similar difficulties quantifying the costs generated by ESMA's proposed option 1 on cross-shareholdings but stressed that it would lead to substantive additional costs to the extent that it would imply the separation of a large number of entities which are currently linked by a qualifying holding or are part of the same group, or the transfer of assets to a different depositary.
31. One respondent (a trade association) provided rough cost estimates arising from option 1. these were estimated to range between EUR 80,000 (for a small member) to EUR 2,100,000 (for a large member). In case a transfer of the affected UCITS assets to an alternative depositary was considered, this respondent mentioned that the costs lined to that transfer would range between EUR 150,000 (for a small member) to tens of millions of EUR (for a large member). In terms of loss of earnings on the side of the substituted depositary, these could, in case of a large member, amount to up to EUR 30,000,000.
32. Other respondents, while not quantifying the likely costs, identified a range of one-off costs including: upfront costs for appointing new and external depositaries to service entire ranges of funds; a change in the ownership structures of business groups; and consultancy charges. Regarding ongoing costs, meanwhile, some stakeholders expected these to come from the loss of economies available through the use of common infrastructure, from access and understanding of new systems, as well as from a time-consuming need to identify and reappoint responsible persons.
33. Respondents also provided data on the number of entities that would be affected by the proposals in certain Member States (please see paragraph 125 of the feedback statement for more details).
34. Regarding the second option on cross-shareholdings, stakeholders expected costs to arise from the setting-up of alternative organisational arrangements, including compensation for members of the management/supervisory board which would need to be substituted. One respondent mentioned that the costs for this option would mainly be related to the implementation of procedures concerning the identification, management, monitoring and disclosure of conflicts of interest. Two banking associations pointed out that the requirement to have a certain number of independent directors may mean that a bank will have to have a representative from one of its competitors and may be problematic as a limitation of external mandates may apply at the top of the organisations.
35. In general, respondents focused their input on underlining what they saw as the much higher costs that would arise from option 1.

Benefits



36. The expected benefits of the proposed approach on common management/supervision and cross-shareholdings are that it provides clarity on the independence requirements of the Level 1 and helps ensure that the objectives of the Directive will be achieved.

3.3 Annex III – Technical advice

I. Advice on the insolvency protection of UCITS assets when delegating safekeeping (Art. 22a(3)(d) and 26b(e) UCITS V)

1. In case of delegation of the functions referred to in Article 22(5) of Directive 2009/65/EC, in order to ensure that in the event of insolvency of the third party, assets of a UCITS held by this third party in custody are unavailable for distribution among or realisation for the benefit of creditors of the third party, the third party shall take steps including, but not limited to, the following:
 - (a) whenever the applicable insolvency laws and jurisprudence are those of a jurisdiction located outside the Union,
 - (i) make all reasonable efforts, including the receipt of legal advice from a natural or legal person not affiliated to the third party, to verify that the applicable insolvency laws and jurisprudence:
 - recognise the segregation of the UCITS' assets from the third party's own assets and from the assets of the depositary, in line with the requirements of Article 22a(3)(c) of Directive 2009/65/EC, as further implemented by [the delegated acts foreseen under Article 26b(1)(d) of the UCITS Directive]; and
 - recognise that the UCITS' segregated assets do not form part of the third party's estate in case of insolvency and are unavailable for distribution among or realisation for the benefit of creditors of the third party;
 - (ii) ensure that the conditions set out in the applicable insolvency laws and jurisprudence to consider that the UCITS' assets are segregated and unavailable for distribution or realisation, as referred to under point (i), are met at the moment of the conclusion of the delegation agreement with the depositary and on an ongoing basis for the entire duration of the delegation;
 - (iii) immediately inform the depositary in case any of the conditions mentioned under (ii) is no longer met;
 - (b) whichever jurisdiction – inside or outside the Union – the applicable insolvency laws and jurisprudence relate to,
 - (i) inform the depositary about the applicable insolvency laws and jurisprudence and the relevant conditions that apply;
 - (ii) maintain accurate and up-to-date records and accounts of UCITS' assets that readily establish the precise nature, amount, location and ownership status of those assets. The records should also be

maintained in such a way that they may be used as an audit trail;

- (iii) provide a statement to each depositary on a regular basis detailing the UCITS' assets held for or on behalf of such depositary; and
- (iv) maintain appropriate arrangements to safeguard the UCITS' rights in its assets and minimise the risk of loss and misuse. In particular, the third party shall 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;

2. In case of delegation of the functions referred to in Article 22(5) of Directive 2009/65/EC, in order to ensure that in the event of insolvency of the third party, assets of a UCITS held by this third party in custody are unavailable for distribution among or realisation for the benefit of creditors of the third party, the depositary delegating the functions to a third party shall adopt the following measures:

(a) in all cases, consider the following elements in the selection and appointment of the third party:

- the legal requirements or market practices related to the holding of client assets that could adversely affect UCITS' rights during business as usual and in the event of insolvency of the third party;
- the financial condition, expertise and market reputation of the third party; and
- protection or lack thereof attendant upon the regulatory status of the third party;

(b) in case the third party is located outside the Union,

- (i) make all reasonable efforts, including the receipt of legal advice from a natural or legal person not affiliated to the depositary, to understand the material effects of the contractual provisions governing the arrangement with the third party on the UCITS' rights in respect of its assets, including how those contractual provisions would operate in the jurisdiction where such assets are held, including in the event of insolvency of the third party to which the depositary has delegated safekeeping duties;
- (ii) ensure that there are contractual provisions in its agreement with the third party allowing the termination of such agreement without undue delay, taking into account the need to act in the best interest of the

UCITS and the investors of the UCITS, in case the applicable insolvency laws and jurisprudence no longer recognise the segregation of the UCITS' assets in the event of insolvency of the third party or the conditions set out under these laws and jurisprudence are no longer fulfilled; and

- (iii) in case the depositary becomes aware that the applicable insolvency laws and jurisprudence no longer recognise the segregation of the UCITS' assets in the event of insolvency of the third party or the conditions set out under these laws and jurisprudence are no longer fulfilled, immediately inform the investment company or the management company on behalf of the UCITS of such a situation. The mere provision of information to the investment company or the management company on behalf of the UCITS shall not change the legal nature of the assets held by the third party, which shall continue to be held in custody.

3. On receipt of the information referred to under paragraph 2(b)(iii), the investment company or the management company on behalf of the UCITS shall immediately notify its competent authority of such information and consider all the appropriate measures in relation to the relevant assets of the UCITS, including their disposal taking into account the need to act in the best interest of the UCITS and the investors of the UCITS.
4. Whenever the legal advice referred to under point (a)(i) of paragraph 1 is made available by the third party to the depositary, the latter shall be absolved of the obligation to obtain legal advice set out under point (b)(i) of paragraph 2.
5. Whenever the legal advice referred to under point (b)(i) of paragraph 2 is made available by the depositary to the third party, the latter shall be absolved of the obligation to obtain legal advice set out under point (a)(i) of paragraph 1, provided that the relevant independent legal advice obtained by the depositary covers all the elements mentioned under point (a)(i) of paragraph 1.
6. Where the third party, in turn, sub-delegates the functions referred to in Article 22(5) of Directive 2009/65/EC, contractual arrangements shall be put in place to ensure that paragraphs 1, 2, 3 and 4 apply *mutatis mutandis* to the relevant parties.

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

1. In order to fulfil the independence requirement referred to in Article 25(2) of Directive 2009/65/EC, the following requirements shall be complied with:

Common management/supervision

- (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;
- (c) where the management body of the management company/investment company is not in charge of the supervisory functions, no more than one third of the members of the body in charge of the supervisory functions of the management company/investment company shall be a member of the management body, the body in charge of the supervisory functions or an employee of the depositary;
- (d) where the management body of the depositary is not in charge of the supervisory functions, no more than one third of the members of the body in charge of the supervisory functions of the depositary shall be a member of the management body, the body in charge of the supervisory functions or an employee of the management company/investment company;

Cross-shareholdings

- (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 sole interest of the UCITS and the investors 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 influence 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

depository in which that holding subsists; or

- the management company/investment company and the depository 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 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 the investors of the UCITS;
- (ii) the management company/investment company shall demonstrate to the competent authority of its home Member State that it is satisfied that the appointment of the depository is in the sole interests of the UCITS and the investors of the UCITS, in particular by comparing the relative merits of appointing the depository versus another depository which is not linked to the management company/investment company. This comparison shall take into account such aspects as the costs of appointing the depository, the expertise and financial standing of the depository and the quality of services provided by the depository;
- (iii) the link between the management company/investment company and the depository shall be disclosed to investors;

and

- (iv) the choice of the depository shall be justified to investors upon request; and
- (g) in case the management company/investment company and the depository 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 the following additional arrangements shall be put in place:
- (i) at least one-third (33%) or two (persons), whichever is the lesser, of the members of the management body of the management company/investment company and the depository shall be independent;
 - (ii) where the management body of the management company/investment company and the depository is not in charge of the supervisory functions, at least one-third (33%) or two (persons), whichever is the

lesser, of the members of the body in charge of the supervisory function shall be independent.

2. For the purpose of paragraph 1(g)(i), members of the management body of the management company/investment company and the depositary shall be deemed independent where they are not members of the management body or the body in charge of the supervisory function nor employees of any of the other undertakings within the group and are free of any business, family or other relationship with the management company/investment company, the depositary and any of the other undertakings within the group that creates a conflict of interest such as to impair their judgment.
3. For the purpose of paragraph 1(g)(ii), members of the body in charge of the supervisory function shall be deemed independent where they are not members of the management body or the body in charge of the supervisory function nor employees of any of the other undertakings within the group and are free of any business, family or other relationship with the management company/investment company, the depositary and any of the other undertakings within the group that creates a conflict of interest such as to impair their judgment.