The on-going review of UCITS (UCITS V) focuses mainly (1) on aligning UCITS depositary rules with those adopted in the AIFMD

The objectives of the UCITS V proposal regarding depositary requirements published by the Commission in July 2012 are to:

- Align UCITS depositary rules with AIFMD rules
- Align depositary requirements across EU jurisdictions. At present depositary responsibilities and liabilities are discharged in different ways across the EU due to insufficient precision of rules leading to different interpretations. Responsibilities and liabilities in case of sub-custody in particular differ across EU jurisdictions, ranging from monitoring responsibilities to strict liability and obligation to return the assets in case of loss.
- Address conflict of interest issues raised by the Madoff fraud regarding particularly conditions for delegating custody (in order to avoid the delegation of asset management and safekeeping functions to the same entity)
- Adapt depositary rules to evolutions in UCITS environment (eligible assets more complex following UCITS III eligible assets rules, assets increasingly safekept outside the EU...)

These proposals will be under review in the coming months whereas the Level II proposals for AIFMD should be published in September 2012.

Scope of UCITS V evolutions regarding depositaries

<table>
<thead>
<tr>
<th>Main UCITS V requirements regarding depositaries:</th>
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<tbody>
<tr>
<td>• Clarification of eligibility criteria (credit institutions and MiFID regulated investment firms)</td>
</tr>
<tr>
<td>• Clarification of the conditions under which custody delegation is possible (due diligence rules, on-going monitoring) with additional requirement to guarantee that in case of custodian insolvency the assets of the UCITS are protected from the creditors of the sub-custodian</td>
</tr>
<tr>
<td>• Description in fund prospectus of safekeeping arrangements</td>
</tr>
<tr>
<td>• Alignment of the liability regime on AIFMD requirements (strict liability regime with obligation to return lost instruments unless the depositary can prove that the loss is due to an “external event beyond its reasonable control”)</td>
</tr>
<tr>
<td>• Impossibility for UCITS depositaries (unlike in AIFMD) to transfer custody liability to third parties through a contract with the AIFM</td>
</tr>
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<table>
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<tr>
<th>Main pending issues in fund regulation regarding depositary requirements:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Possible role of depositaries for venture capital and social business funds remaining to be finalised</td>
</tr>
</tbody>
</table>

(1) UCITS V also includes rules related to:
- The remuneration of asset managers (introducing policies consistent with sound risk management, disclosure of the amount of remuneration)
- Sanctions (minimum harmonization of the sanctioning regimes: minimum catalogue of administrative sanctions, minimum list of sanctioning criteria, whistle-blowing mechanisms)
The impacts of the AIFMD / UCITS V liability regime for depositaries will need to be monitored over time

- The AIFM Directive and the UCITS V review clarify fund depositary functions and change quite significantly their liability regime.
- These new rules, which are due to be implemented in 2013, may have major impacts on the market, according to the industry, which will need to be monitored over time. A reinforced cooperation between the different players on the value chain i.e. asset managers, depositaries, prime brokers... will also be required in this perspective so that the respective duties, constraints and scope of accountability are well understood and clearly defined.

### Issues to be monitored over time: possible impacts of the AIFMD / UCITS V depositary liability regime

<table>
<thead>
<tr>
<th>Possible impacts to be evaluated over time:</th>
</tr>
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<tbody>
<tr>
<td>• Possible exit of custodians from some markets (e.g. certain developing / emerging countries) potentially resulting in cost increases due to reduced competition or resulting in some countries not being covered by custody services (depending on the legal framework and the level of supervision of sub-custodians).</td>
</tr>
<tr>
<td>• Higher custody costs with possible negative impacts on investments in EU funds by fund of funds or hedge funds, compared to funds domiciled in other regions and which may not be subject to such requirements</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Issues and implementation conditions to be verified:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Possibility for depositaries to mitigate appropriately custody risks in the context of reinforced liability with due diligence and monitoring processes</td>
</tr>
<tr>
<td>• Possibility for depositaries to contractually discharge their liability as allowed in the AIFMD: some depositaries put forward the difficulty of negotiating in advance the practices or markets for which such a contractual discharge may be needed</td>
</tr>
<tr>
<td>• Challenges for depositaries in monitoring custody risks for assets held in collateral by third party brokers (i.e. prime brokers) have been pointed out, in the case when these assets have been pledged* and are no longer held by the fund depositary, as such pledged assets may be re-used. Many depositaries consider that they may not be able to exert sufficient control over the assets in this case. There are various options to address this issue, which are at present under review. One is the institution of a tri-partite custody arrangement. Other options are that the prime broker be appointed as a sub-custodian of the depositary or the prime broker be appointed as the depositary itself.</td>
</tr>
</tbody>
</table>

*Collateral posted with a transfer of title does not raise the same issues since they are outside the safekeeping responsibility of the depositary.
The question of the UCITS depositary passport is addressed in the consultation launched by the Commission in July 2012

**Present rules: UCITS IV**

- **The fund depositary is required to be based in the same country as the fund**
  - The main reason is that this facilitates the control by the depositary that fund management and administration activities are conducted according to fund domicile rules (oversight function of the depositary) in a context where responsibilities and fund rules may vary across jurisdictions (e.g. reporting, delegation rules, valuation methods...) as well as tax rules and some local regulations (e.g. bank secrecy rules).
  - This also facilitates interactions between the fund regulator and the depositary, with depositary responsibilities and liabilities also varying at present across the EU.

- **Most other activities can be provided on a cross-border basis**
  - Asset safekeeping may be delegated outside the fund domicile, as well as other administrative functions (fund administration, transfer agent)
  - UCITS and AIFs may be managed by a management company based outside the home country of the fund, according to UCITS IV and AIFMD, provided certain conditions are met (for UCITS designation of a contact person, rules for handling complaints, attestation by the fund domicile regulator...)

![Diagram showing fund domicile, management company domicile, and activities possibly performed on a cross-border basis]

- Fund domicile
  - Fund depositary
  - Fund auditor
  - Fund regulator

- Management company domicile
  - Management company
  - Management company regulator
  - Management company auditor

- Activities possibly performed on a cross-border basis
  - Sub global custodians
  - Sub-custodians
  - Transfer agent
  - Administrator
The progressive harmonization of fund rules with UCITS IV/V could contribute to facilitating the cross-border operation of UCITS depositaries in the EU

Expected benefits and issues to be addressed regarding a possible UCITS depositary passport

- Allowing UCITS depositaries to operate on a cross-border basis would notably facilitate master-feeder arrangements (1) with vehicles authorized in different EU countries and could potentially help depositaries to increase economies of scale in a context where costs may increase due to stricter liabilities
- This would however require some conditions to be fulfilled or further assessments to be conducted:
  - The effective implementation of harmonized fund and depositary rules: for example verifying that the interpretation of an “external event” in the context of depositary liabilities is enforced legally in the same way in all countries and will not be influenced by possible differences in local jurisprudence
  - The harmonisation of eligibility criteria (i.e. who is allowed to act as depositary)
  - Analyzing the impacts on liabilities of differing legal and tax rules across the EU e.g. differing securities laws with regard to custody arrangements before the SLD (Securities Law Directive) is in place, differing bankruptcy laws...
  - Evaluating the impact of different local rules regarding e.g. valuation of assets and oversight functions which will persist
  - Evaluating more precisely the capacity for supervisors to coordinate and manage a possible crisis involving a fund for which the depositary, the management company and the fund are all domiciled in different jurisdictions
- The same issues need to be addressed for AIFs. Transitional provisions of the AIFMD (Article 61.5) may enable the competent authorities of the fund domicile to allow institutions based in another Member State to be appointed as AIF depositary. The implementation of harmonized and clarified rules for AIF depositaries and management companies in AIFMD should contribute to facilitating the operation of AIF depositaries on a cross-border basis. Some fund rules may however continue to differ, as there is no harmonised EU product framework for AIFs.

(1) Pooling of separate fund vehicles (corresponding for example to different investor groups) into a master fund