

# UCITS V is coming soon with a focus on depositaries and remuneration

As expected, the EU Commission has launched a consultation as a pre-cursor to Undertaking for Collective Investment in Transferable Securities (UCITS) V legislative proposals to be tabled in Spring 2011.

## Why UCITS V?

The urgency of this initiative is largely explained by Alternative Investment Fund Managers Directive (AIFMD) and one of the most contentious issues that dogged the negotiating process: the role, responsibilities, and importantly, the liability of the depositary. This consultation also deals with remuneration.

The Commission launched a consultation on the role of UCITS depositaries last year and determined that a clarification of depositary functions was required. In addition, to the extent that AIFMD provides greater clarity and definition on the role and liability of the depositary, it is clearly right that UCITS should have at least as stringent and clear a set of depositary requirements and rules as AIFs, given that AIFs are by nature in large part, institutional vehicles, and UCITS were designed for the retail market.

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## What's in this Consultation?

The Commission's objectives are to:

- Clarify the depositary function
- Ensure consistency with role of depositary under AIFM
- Improve investor protection

## Definition/clarification of the meaning of safekeeping

In line with AIFM, the Commission recognises a difference between those assets that can be held in custody, i.e. in the name of the fund on the book of the depositary, and those that cannot be held in custody, i.e. derivatives where only monitoring rather than physical safekeeping is possible. The Commission also proposes a requirement for asset segregation and explicit obligations in respect of cash.

## Oversight function

The Commission has noted that there are inconsistencies in defined oversight duties depending on whether the UCITS is in corporate or trust form. The Commission seeks to align the requirements and further to harmonise the detailed technical and operational requirements that should apply in respect of each of a depositary's duties.

## Delegation

In respect of delegation of depositary functions, i.e. to a sub-custody network, the Commission proposes to align the requirements with those set out in AIFMD. Delegation would only be permitted in respect of safekeeping duties and it is envisaged that there would be a disclosure requirement specifying the risk of sub-custodian failure and how that risk can be mitigated.

## Liability

The Commission seeks to make a distinction between an unjustifiable failure to perform depositary duties (e.g. negligent or intentional failure to perform) and circumstances when a failure to perform might be justified.

Liability in respect of assets that are lost is a contentious issue. AIFMD requires that a depositary must return lost assets without undue delay but provides the possibility of contractual discharge of that obligation. The Commission proposes that there should be no such discharge possibility in respect of UCITS and that the depositary could only escape the restitution obligation in cases of force majeure.

## Burden of proof

It is the Commission's intention that the inversion of the burden of proof as provided for in AIFMD should be extended to UCITS i.e. that it is incumbent on the depositary to prove that duties have been properly performed.

## Eligibility

The Commission intends to set out an exhaustive list of the types of institution that would be qualified to undertake depositary duties in respect of UCITS. The list is expected to include credit institutions and Markets in Financial Instruments Directive (MiFID) firms, with grandfathering for those cases where existing arrangements differ.

## Depositary Passport

The Commission believes that once the new depositary requirements have come into force, consideration should be given to an EU-wide depositary passport.

## Supervision by National Regulators/Supervisors

The Commission is concerned at the lack of consistency in supervisory competence amongst Member States and proposes that harmonisation may be desirable.

## Audit Supervision

It is proposed that auditors be required to provide an annual certification of UCITS assets.

## Remuneration

It would have been odd if the Commission had not introduced proposals at this stage on remuneration given the focus that this issue has had and the inclusion of remuneration rules in AIFMD.

The Commission therefore proposes to include sound remuneration principles in its legislative proposal. These rules would be designed to promote sound and effective risk management and discourage any risk taking that is inconsistent with the risk profile of the UCITS being managed, prevent conflicts of interest and protect investor interests.

The Commission is seeking feedback on the impact of its proposed changes on the UCITS industry and its stakeholders by 31 January 2011.

**Alongside this there are the following:**

- A consultation on reinforcement and convergence of financial sector sanctions
- A Green Paper on corporate governance in financial institutions
- A proposed extension of the Investor Compensation Scheme to UCITS investors
- The Securities Law Directive
- A consultation on Packaged Retail Investment Products

All of the above may have a bearing on the scope and content of UCITS V when it appears in early 2011. It seems there is no let up in the field of regulation and we can look forward to a new year with many more challenges.