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CZECH REPUBLIC

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

Opinion of the Czech National Bank

UCITS Depositary Function

Box 1

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

Box 2

It is envisaged to complete articles 22 and 32 of the UCITS Directive,26 in a way which is consistent with the approach in the AIFM Directive, in order to:

- Distinguish safekeeping duties between (1) custody duties relating to financial instruments (such as securities) that can be held in custody by the depositary and (2) asset monitoring duties relating to the remaining types of assets. A reference to the custody of physical assets, such as real estate or commodities, is not necessary because such assets are currently not eligible for holding within a UCITS portfolio;27

- Supplement the requirements on custody duties with a segregation requirement, so that any financial instruments on the depositary's book held for a UCITS can be distinguished from the depositary's own assets and at all times be identified as belonging to that UCITS; such a requirement would confer an additional layer of protection for investors should the depositary default

- Equip the depositary with a view over all the assets of the UCITS, cash included.28 The directive should more explicitly make clear that no cash account associated with the funds' transactions can be opened outside of the depositary's acknowledgement, with a view to avoiding the possibility of fraudulent cash transfers;

- Introduce new implementing measures in the mentioned Articles defining detailed conditions for performing depositary monitoring and custody functions, including (i) the type of financial instruments that shall be included in the scope of the depositary's custody duties; (ii) the conditions under which the depositary may exercise its custody duties over financial instruments registered with a central security depositary; and (iii) the conditions under which the depositary shall monitor

financial instruments issued in a nominative form and registered with an issuer or a registrar.

Opinion of the CNB: In our opinion, the safekeeping duties of a depositary should be specified at the European level.

The proposed differentiation of assets in line with legal and technical possibilities of safekeeping by the depository seems logical to us. The Czech Republic already applies it.

We support the requirement for segregating the depositary's or sub-custodian's assets from the assets of UCITS funds held in custody by these entities.

Box 3

It is envisaged to achieve a higher degree of consistency in the oversight duties to be performed by UCITS depositaries: the oversight duties related to UCITS with a corporate form should be aligned with those to be performed in respect to UCITS with a common fund form (article 22).

Box 4

It is envisaged to introduce implementing measures that will clarify further the scope of each listed supervisory duty, for example the methodology to be used for the calculation of the Net Asset Value of the UCITS.

Opinion of the CNB: In view of the fact that the control duties are closely related to the subsequent responsibility of the depositary, we deem it useful to define them more precisely. Control duties should be defined so that the depositary's responsibilities are clear.

It is important, in our opinion, to clearly specify, whether the depositary should check orders ex ante (before the execution or other settlement of a transaction) or ex post (after the order has been carried out). In line with Czech experience, we recommend to set generally the depositary's obligation to make ex ante controls. We then recommend to make ex post controls if the amount involved in the order is low (currently EUR 20,000 in the Czech Republic) or if the order concerns specific instruments (e.g. money market instruments, listed investment instrument, collective investment undertakings' securities).

Box 5

It is envisaged to restrict more explicitly the delegation of the depositary task to the safekeeping duties and that the conditions and requirements upon which a UCITS depositary may entrust its safekeeping duties to a third party should be aligned with those under the AIFM Directive.

It is also envisaged to require additional information for UCITS investors be published (for example in the prospectus) where a network of sub-custodians is to be used. Such information would specify the risk that such a sub-depositary network might fail or default, and how this risk can be dealt with.

Finally, implementing measures are envisaged in order to detail the depositary's initial and on going due diligence duties, including those that apply to the selection and appointment of a sub-custodian.

Opinion of the CNB: In our opinion, an essential requirement is that the depositary should be fully liable for assets entrusted to him even if he delegates some activities to a third party. We consider as reasonable that the rules for delegating the mandate are in line with the requirements stipulated in the MiFID (Article 13(5)). We support that the delegation of some activities should not endanger the prerequisites for carrying out the depositary's activities. The delegation of activities to a third party should be conditional on the conclusion of a written agreement, which will not allow to release the

fund's assets without the depositary's consent, allow the depositary to suspend the execution of an order or take over the fund's assets and control the third party's activities.

We consider as justified to restrict the outsourcing of the depositary's activities, as under the AIFM directive, to safekeeping of assets that the depositary cannot safekeep itself, as this better protects investor' interests. Informing investors about the outsourcing is useful in our opinion, if the manner of informing is appropriate (it would be sufficient to mention it in the fund's prospectus).

Box 6

It is envisaged that the depositary liability regime might be clarified in case of a UCITS suffering losses as a result of a depositary's negligence or intentional failure to perform its duties.

Box 7

It is envisaged to clarify the UCITS depositary liability regime in case of loss of assets. Accordingly, the UCITS depositary shall be under the obligation to return the financial instruments of the identical type or of the corresponding amount to the UCITS. No further discharge of liability in case of loss of assets is envisaged, except in case of force majeure. Implementing measures should be introduced, as necessary, to clarify all necessary underlying technical aspects, for example to identify the circumstances under which assets may be lost.

Box 8

As already provided under art. 22 and art. 32 of the UCITS directive, it is envisaged to maintain the rule according to which the depositary's liability is not affected if it has entrusted to a third party al or some of its safekeeping tasks. As a result, the depositary faces the same level of liability, should the UCITS assets be lost by a sub-custodian. Moreover, it is envisaged that the legislative proposal should clarify the fact that if assets are lost, the UCITS depositary liability regime has the general obligation to return the financial instruments of the identical type or of the corresponding amount to the UCITS with no delay.

As mentioned above, no further discharge of liability (either regulatory or contractual) in case of loss of assets by a sub custodian shall be envisaged, except in case of "force majeure".

Box 9

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

Box 10

It is suggested to align the rights of UCITS investors, so that both share- and unit-holders are able to invoke claims relating to the liabilities of depositaries, either directly or indirectly (through the management company), depending on the legal nature of the relationship between the depositary, the management company and the unit-holders.

Finally, implementing measures should also be introduced in order to encourage a high degree of harmonisation, for example to detail the conditions and procedures under which shareholders may directly use their rights towards a UCITS depositary.

Opinion of the CNB: We recommend to introduce a minimum standard for civil liability for improper performance by a European regulation. For example, the Czech Republic applies objective liability without transferring the burden of proof on the depositary. We recommend that this standard is preserved.

It is desirable that the role of a depositary in the case of liability for safekeeping and control of assets entrusted to him be clarified and unified at the European level. In our opinion, the depositary should be fully liable for entrusted assets, even in the case that they are lost by a third party (a sub-custody).

The existing practice does not justify the transfer of the burden of proof on the depositary. This could result in an increase of unjustified actions against depositaries, i.e. to a higher legal (operational) risk for depositaries. In addition, it can be supposed that this increased risk would lead to higher expenses on the depositary's activities, which will eventually be paid by investors. Moreover, transferring the burden of proof on the depositary does not mean any essential step towards the improvement of the level of the depositary's activities.

In the Czech Republic, investors already have the right to sue the depositary if the depositary fails to comply with its duties. We support the introduction of the right to sue depositaries directly (without intermediation by a management company) also at the European level.

Box 11

It is suggested to introduce an exhaustive list of entities that should be eligible to act as UCITS depositories, aligned with the AIFM Directive list. Such a list should include: credit institutions, authorised MiFID firms which also provide the ancillary service of safe-keeping and administration of financial instruments, and existing UCITS depositary institutions (by means of a grandfathering clause).

Opinion of the CNB: We propose that only institutions covered by the CRD can be authorised to carry out the activities of the depositary. We believe that only institutions subject to the CRD, i.e. to the respective capital and organisational requirements, are able to ensure the required degree of investor protection and bear the responsibility arising from the activity of the depositary. This requirement is a minimum in our opinion. Member countries should be allowed to set potential tighter criteria and requirements for entities carrying out the depositary's activities (e.g. restriction only to banks, as applied in the Czech Republic). The above definition of eligible entities will moreover resolve also the organisational and operational requirements, the audited annual accounts, licence and supervision duties (see Opinions of the CNB to Boxes 14 and 17).

Box 12

It is envisaged that a provision is introduced into the UCITS Directive creating a commitment to assess and re-examine the need to address depositary passport issues, to be undertaken a few years after the new UCITS depositary framework has come into force.

Opinion of the CNB: We are not against the possibility of introducing the single European passport for carrying out the activities of a depositary. We point out potential risks, which must be appropriately treated prior to its introduction. The introduction of the single European passport for depositaries must be preceded by consistent harmonisation of regulatory rules for their activities at the European level. Of crucial importance is also the requirement for a clear definition of powers and obligations of the individual supervisory authorities and their cross-border cooperation. At the same time we consider as important that the host supervisor is authorised to conduct on-site examinations and that the specific conditions regarding depositary responsibilities are unified as well (e.g. the issues relating to the bodies authorised to impose sanctions if the depositary fails to comply with its duties). Depositary passportisation could otherwise lead to a decline in quality of its performance (higher operational risk, e.g. as a result of the situation that a cross-border operating depositary would check the valuation of securities and the NAV calculation under different regulations in each country).

Box 13

Differences between national supervisors' scope of competencies lead to an uneven supervisory framework, suggesting that such competences might be better harmonised. In the Commission's view, this remains a key issue to be addressed in order to fully achieve due levels of harmonisation in practice for the depositary function at the Community level.

Opinion of the CNB: Harmonisation of the minimum standard for administrative authorisation of supervisory authorities is desirable in our opinion. We assume that the Czech Republic is already compliant with this standard. The consultation material notes that some supervisors are authorised to resolve civil disputes between depositaries and investors (damage compensation). We fundamentally disagree with such authorisation (obligation) for the CNB. Such issues must remain in the competence of civil courts.

Box 14

The introduction of a requirement for an annual certification of the assets held in custody by the depositary would clarify the true existence of such entrusted assets. This annual certification could be performed by the depositary's auditors. Details related to any such requirement might need to be further defined in implementing measures or technical standards as appropriate.

Opinion of the CNB: We fully agree with the obligation of annual accounts certification by an independent auditor. Depositaries in the Czech Republic (only banks and foreign bank branches) already have such obligation. In the Czech Republic, financial statements of mutual funds and management companies are verified by an independent auditor every year.

Box 15

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

Opinion of the CNB: The Czech Republic has not used this discretion in the implementation of the UCITS Directives. Apparent reasons for having not used this discretion were a protection of investors and the fact, that allocation of collective investment undertakings' securities via the regulated market is not virtually applied in the Czech Republic. In this regard, we have no objections to this rule.

Box 16

It is suggested that the requirement for a single depositary per UCITS should be clarified (without prejudice to Article 113(2) of the UCITS Directive n°2009/65/EC).

Opinion of the CNB: We consider the setting of the principle of „a single depositary" for each fund at the European level desirable. In the Czech Republic, this principle already applies.

Box 17

It is suggested to:

Introduce for UCITS depositaries similar rules of conduct as in the AIFM Directive, in addition to the already existing rules stated in the article 22 and 32 of the UCITS Directive;
Introduce implementing measures in order to encourage a higher degree of harmonisation and consistency between the organisational requirements applicable to all functions of the UCITS depositary (safekeeping as well as oversight) and, where appropriate, the existing MiFID requirements.

Opinion of the CNB: In our opinion, the harmonization of the depositary duties to act honestly, fairly and professionally, independently and exclusively in the interests of investors at the European level is appropriate. In the Czech Republic, these requirements are already imposed on depositaries.

In our opinion, to set organizational requirements on depositary activities of UCITS funds is not necessary, provided, that the admissible institutions authorized to carry on depositary activities have sufficient capital, as, for example, institutions subject to the CRD Directive. If also other entities were

authorized to carry on depositary activities, it would be necessary that they followed the same rules for security, organization and operation as credit institutions.

Special attention should be paid to the area of conflict of interests. In the case of depositaries performing more various activities or depositories from the group, the independence of the performance of their functions in terms of material or personal facilities (e.g. if the management company delegates many of asset management activities – risk management, valuation of assets, the calculation of Net Asset Value to an entity providing at the same time depositary service) may be endangered (often due to an effort to use synergies).

Box 18

It is suggested to amend existing requirements concerning the disclose of information to the competent authorities, on their request, in such a way that any information, obtained by a depositary while carrying out its duties, should be made available to its competent authorities if such information may be necessary for these authorities.

Implementing measures should also be introduced in order to, for example to detail the conditions and procedures under which UCITS depositaries shall exchange information with their supervisors.

Opinion of the CNB: In the Czech Republic, the supervisory authority has the competence to require from the depositary any information necessary for the performance of supervision. In this regard, we have no objections to this rule.

Box 19

It is suggested that the requirements set out in Article 23(5) and Article 33(5) of the UCITS Directive and their corresponding implementing measures should also apply to a situation where the management company home Member State is also a UCITS home Member State.

It appears opportune to require the UCITS depositary to follow conduct of business rules which would oblige a depositary to act honestly, fairly, professionally, independently and in the interest of the UCITS and investors of the UCITS. Furthermore, the depositary should be required to establish appropriate policy for identification, management, monitoring and disclosure of the conflict of interests which may arise when a depositary carries out activities with regard to the UCITS.

Opinion of the CNB: We consider the enhancement of the requirement to adjust mutual information duties between the management company and the depositary resident in one Member State through the depositary agreement, logical. In the Czech Republic this rules already applies.

UCITS Managers' Remuneration

1 a) Do you agree that to maintain a level playing field in the financial services sector, remuneration policy for UCITS management or investment companies should broadly follow similar rules contained in the AIFM Directive or CRD III, so as to ensure a consistent approach to remuneration policy across all financial sectors? If not, please explain and justify your views.

Opinion of the CNB: We agree that basic remuneration principles (see the final summary of acceptable principles) should be applied within the entire financial sector, i.e. also to managers of UCITS. However, we consider some rules of the AIFM and CRD III Directives not to be very appropriate, partly very concretized and we do not agree with their introduction for UCITS managers. More details to be found in answers to the following questions.

1 b) Do you agree that the proposed approach to the regulation of remuneration policy for UCITS managers includes all requirements that should be covered? Can you identify

any other options or approaches that might be more effective?

Opinion of the CNB: We believe, that the UCITS Directive should contain complete, but only the basic, generally expressed remuneration principles, which are included in the AIFM and CRD III Directives. We propose, therefore, to supplement the principle of remuneration of control functions (remuneration should be independent of controlled units' performance) and the principle of the inclusion of considering the risks and costs in measuring the assessment of employees performance into the UCITS Directive.

We do not agree with the principle of review of the implementation of remuneration principles by compliance function, since in our opinion, it is on the institution itself, to determine, according to its internal structure and relationships, who will perform the internal control of remuneration principles. In compliance with the AIFM and CRD III Directives we propose, that the UCITS Directive generally stipulates, that the functioning of remuneration principles is subject to an independent internal review.

We also agree with the CESR proposal given directly in the document, that the aggregated data on remuneration should be regularly disclosed and we propose to supplement this requirement to the UCITS Directive. Information on the manner of remuneration and the aggregated amount of compensation will enable customers a better orientation and comparison of individual collective investment entities. In our opinion, the publication of the aggregated data is sufficient.

1 c) Do you consider certain requirements more important than others?

Opinion of the CNB: In our opinion, the principles stipulating general objectives of the remuneration regulation and thereby facilitating national regulators and supervisory authorities to apply the rules with regard to the individual conditions of UCITS managers, are important.

1 d) Do you believe that certain principles, or elements of these, are not suitable for UCITS managers or not appropriately tailored? If so, please suggest alternative ways of tailoring the general principles.

Opinion of the CNB: In our opinion, the application of the rules for the fixed and variable component of remuneration would not be appropriate for UCITS mangers. Managers do not trade for their own account, but they manage customers´ assets, which are on separate accounts, in accordance with the set rules. The risk profile of UCITS managers differs from the other financial entities, since it includes almost only the legal and operational risks. The setting of the ratio between the fix and variable elements of remuneration and the deferral of the variable component does not seem to be appropriate in view of the nature of UCITS mangers´ activities. The establishment of the remuneration committee is another redundant rule. Although the proposed text clearly states, that the committee should be established only if it is appropriate, we believe, that it would not be appropriate for any UCITS manager (pursuant to the CRD III Directive and relevant CEBS recommendations, this committee is established only by significant institutions). We propose, therefore, that the principles relating to the Remuneration Committee and fixed and variable components of remuneration are completely omitted.

2. Are there any additional changes than those suggested in this Consultation Paper that should be introduced as regards remuneration policy for asset managers? Please justify or explain your answer and provide objective data to support it.

Opinion of the CNB: We do not propose any further amendments to the Directive on remuneration, which would not be mentioned in the Consultation Document.

3. Please provide us with any evidence you may have on the likely scale and nature of impacts that the suggested rules on remuneration policy may create for UCITS managers and other stakeholders.

Opinion of the CNB: Provided that all the proposed changes are introduced (i.e. rules for the fixed and variable component of remuneration), it could lead to an disproportionate regulatory burdening of UCITS managers. In addition, it can be expected, that there could occur an contra-productive increase in fixed elements of remuneration at the expense of those flexible.

General opinion of the CNB to the problems of UCITS managers' remuneration:

To sum up the aforementioned opinion, we state a list of principles, whose supplementation into the UCITS Directive is acceptable to us:

- The rules should apply only to employees, who can have a significant effect on the risk profile of UCITS funds, particularly the top management including members of authorities, key employees in the internal control functions, employees, whose activities are connected with risk undertaking (risk takers) and other employees, whose remuneration is similarly high as that of the top management.

- In applying the rules, the principle of proportionality should be used, i.e. a possibility to apply the principles appropriately in view of the size, organizational set up, scope and complexity of activities of the institution.

- Governance principles

- the management body in its supervisory function approves, supervises the implementation and reviews remuneration principles,
- an independent internal control should, at least once a year, review compliance of the remuneration system with the remuneration principles approved by the management body in its supervisory function,
- the principles are transparent in relation to the employees in question,
- the institution publishes the aggregated remuneration data.

- The principles for the structure of remunerations
- the manner of setting the performance remuneration for various categories of employees, including the assessment at a longer-term horizon,
- limits on guaranteed variable remuneration,
- specific rules for pension benefits and the payments related to the early termination of contract.