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## **RE: EUROPEAN COMMISSION CONSULTATION PAPER ON THE UCITS DEPOSITARY FUNCTION**

The European Securities Services Forum (ESSF)<sup>1</sup> is pleased to respond to the European Commission's Questionnaire on the UCITS depository function. The clarification of this function and the liability for its execution is of great significant to ESSF members as demonstrated by our 'Position Paper on Fund Depositories' submitted to the Commission on 15 July 2009. The Commission will recall that our Position Paper argues that the trend towards strict liability in certain jurisdictions in wake of the Lehman collapse and Madoff scandal is indefensible under the UCITS Directive and instead advocates that it be made clear that the basis for UCITS depository liability is due care and diligence in the performance and delegation of the depository function.

Summarising our response to the Questionnaire; we support a clarification of depository safekeeping and supervisory duties to enhance consistency across the EU but caution against too much detail. We similarly support a clarification of the liability regime applying to depositaries but specify that this should be based on the responsibility of depositaries to exercise reasonable care and diligence in the performance and delegation of their services. For consistency purposes, we also support a clarification of the organisational requirements applicable to depositaries. For similar reasons we also agree on the need to clarify the entity types eligible to act as depositaries but argue that this should be based on functions provided rather than institutional structure. In terms of supervisory issues we agree that depositaries should be subject to a specific 'depository' approval by national regulators and endorse the creation of a EU passport for UCITS depositaries. Finally, in the context of other investor protection issues, we believe that the UCITS framework should allow the UCITS' net asset value to be calculated fund managers or by an independent valuator.

In the remainder of this paper, we set out our answers to the individual questions of the Questionnaire. We would welcome the opportunity to clarify those responses if the Commission would find that helpful.

### **I. DEPOSITARY'S DUTIES**

#### **A. Safe-keeping duties**

***Question 1) Do you agree that the safe-keeping (and administration) duties of depositaries should be clarified?***

Yes. While we believe that the safe-keeping and administration duties of a Depository under UCITS is sufficiently clear and that the problems referred to by the Commission in its Introduction (the Madoff fraud and the Lehman collapse) do not demonstrate an inherent problem with UCITS, we believe that changes to UCITS to clarify the minimum requirements for a Depository, in the selection and monitoring of sub-custodians, would be beneficial to reassure investor so that these duties are consistently understood and applied throughout Europe. The principles

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<sup>1</sup> The ESSF is the European post trading centre of competence of the Securities Industry and Financial Markets Association (SIFMA). Our members are the major users of international securities markets. Representing its members as towards market infrastructure organisations and public authorities, the ESSF acts as an agent for change providing and supporting solutions in the securities clearing, settlement and custody space to reduce risks and costs to market participants.

we would suggest, which are already expressed in the legislation and regulations of some EU member states (and have been presented to you in our Position Paper of 15 July 2009), include the following

1. The Depositary should be responsible for using reasonable care and diligence when choosing and instructing the sub-custodians, as well as for taking reasonable care to monitor that they remain suitable;
2. The standard of reasonable care should be established by the prevailing industry practice regarding the skills, care and diligence expected of a Depositary, as qualified by local legislation or regulation;
3. When appointing a sub-custodian, the due diligence of a Depositary should include taking reasonable steps to provide for the segregation of the assets of the UCITS funds it supports from the assets of the sub-custodian, in the event of the failure of the sub-custodian (as well as from the assets of the Depositary itself, in the event of the failure of the Depositary);
4. In the event of the failure of a sub-custodian, the Depositary should be required to take reasonable steps towards the expeditious delivery of the assets of the UCITS funds it supports to another sub-custodian. There should not be a presumption that the Depositary owes an obligation towards a UCITS fund to return assets, which are detained due to administrative procedures related to the insolvency of the sub-custodian, immediately and without regard to the operation of local laws in the country where the insolvent sub-custodian is located; which is part of the investment risk associated with investment in a particular market;
5. Fair disclosure of the risks of investing in markets, including the risk of failure of a securities intermediary in a particular market, should be provided to investors in UCITS funds by the fund manager.

***Question 2) Do you agree these duties should be clarified for each class of assets eligible to the UCITS portfolio?***

Yes. The safe-keeping function is – as a matter of fact - tailored to the nature of each asset type. It should be recognised that there are UCITS assets which can be and are physically safe-kept by the Depositary, as well as types of assets which are not held directly by the Depositary but are recorded in book-entry systems or held by other parties such as Central Securities Depositories (CSDs), ICSDs, registrars, brokers or collateral agents. In the case of the latter, requirements are market driven or the agents/counterparties are selected by the Manager or investment managers acting on behalf of the Manager as part of their performance of investment responsibilities which cover stock/asset selection, market/exchange selection and, subject to certain restrictions, counterparty selection. For example:

1. Listed financial instruments are generally held directly by the Depositary or through sub-custodians, selected and supervised by the Depositary.
2. Other eligible assets may not be held by the Depositary or entities selected and supervised by the Depositary but held by agents of the UCITS and counterparties selected by the UCITS's board of directors or its management company. These assets are typically held pursuant to bilateral agreements, which do not involve the Depositary. As the agents of the UCITS and its counterparties are not selected by the Depositary, it is not appropriate or reasonable to expect the Depositary to be held liable for the actions of these parties where losses may be incurred by the UCITS in the normal course of appropriate investment activity (as allowable under the regulations and terms of the prospectus).

***Question 3) Are there any other appropriate approaches?***

Yes. In addition to the role the Depositary plays, the role of other players should be considered. It would be helpful to clarify the responsibilities of the Manager regarding the Manager's selection of asset classes, exchanges and markets for trading and appropriate counterparties,

***Question 4) Do you agree to a common horizontal and functional approach of the custody duties on the listed financial instruments, to be applied to UCITS depositaries?***

No. It is not apparent to us what is being proposed. Generally, a common principles based approach with respect to each type of asset class and what is expected for each type of asset class, but taking into account our points set out above in response to Question 2, across jurisdictions, would enhance transparency and reduce uncertainties for the Depositaries.

***Question 5) Is there some specificity that may be applicable to the custody functions of a UCITS depositary that should be taken into account?***

Any specificity to be taken into account will be discussed under the Questions relating to "II. Responsibility regime"

## B. Supervisory duties

**Question 6) Do you agree that the existing supervisory duties of the UCITS depositary should be clarified?**

Yes. Although we are in favour of harmonisation of those duties across the EU (resulting in (a) equivalent protection regardless of the domicile of the fund in which they have invested, and (b) reduction of the overall cost to the industry), there is a risk of over-regulation if we go beyond the level of detail currently laid down in Article 22(3).

**Question 7) If so, what clarification do you suggest?**

We believe that the duties should be clarified to make it clear that the UCITS Depositary function is to supervise and monitor the actions of a Manager. As the Manager has the primary responsibility for managing the fund in accordance with the regulations, makes the investment decisions, and reports to the appropriate regulatory authorities, we believe that it should be the duty to confirm that the Manager has taken sufficient steps to correct any breaches that occur within a reasonable time.

We do not think that the Depositary should be required to recalculate the Net Asset Value or to duplicate functions of the Manager, but rather that the appropriate processes and procedures are in place and enforced to perform a correct calculation. A full recalculation introduces extra cost. We believe it would be useful to the industry to have Article 22(3) clarified so that standards of materiality and reporting to regulators are harmonized across the EU.

**Question 8) To what extent does the list of supervisory duties need to be extended?**

We do not believe that the list has to be extended.

**Question 9) Do you agree that the 'only one depositary' requirement should be clarified?**

Yes. We believe the "only one depositary" requirement is clear and that there should be only one Depositary for each fund arrangement, but a Depositary must be able to delegate the safe-keeping of fund assets to sub-custodians, but that will be discussed further in this questionnaire.

## II RESPONSIBILITY REGIME

### A. Liability regime in case of improper performance

#### 1. Identification of the associated risks

- a) Loss of assets
- b) Improper performance of the safe-keeping duties for assets which cannot be held in custody
- c) Improper performance of supervisory duties

#### **Question 10) Do you think that the risks related to improper performance have been correctly identified?**

The risks identified in '**a) Loss of assets**' are correctly identified. We note that it is already established practice to provide for segregation of client assets from those of the depositary, global custodian and subcustodians.

Investment in any country carries with it a number of risks, one of these being that insolvency laws may immobilise investments held within the country, where a sub-custodian becomes subject to insolvency proceedings. In most cases, the investments are not "lost", as they will have been segregated from the assets of the insolvent sub-custodian and recoverable through a legal process. The complexity of the process, and the time that it takes to complete, will depend upon legal process in the relevant country and the circumstances of the insolvent institution.

It would be appropriate to clarify what the responsibilities of the Depositary should be, if investments become immobilised in an insolvency proceeding affecting a sub-custodian. In our view, it is not reasonable to make the Depositary responsible to guarantee the immediate delivery of immobilised assets, as the operation of the insolvency laws of the country where they are held is part of the country risk assumed and shared by investors in UCITS. Best practice should be for the Depositary to take all reasonable steps to secure the release of the immobilised assets of the UCITS and transfer them (if possible) to a replacement sub-custodian, as soon as reasonably practicable.

As we noted in our 15 July Position Paper, we have noted that there has been recent experience on Europe, which illustrates the challenges for Depositaries, when assessing the ability of subcustodians to perform their function on a continuous basis. A prime example is afforded by the situation with Fortis, which acted as subcustodian in the Netherlands and Belgium for other institutions, including Fund Depositaries. The deterioration of Fortis' condition, in late 2008, was sudden and dramatic. Had it not been provided with government aid, it could have failed outright with very little warning. It is not evident that Fund Depositaries would have been in any better position than creditors, depositors and other interested persons to identify that the risk of failure was imminent; nor that they would have been in a better position to take measures to move assets to another subcustodian prior to any failure. Had the failure of Fortis resulted in the immobilisation of securities or their loss, and had Fund Depositaries been under a strict duty to return fund assets, without regard to the insolvency proceedings that would have had to take place, the shifting of risk to Fund Depositaries could have caused contagion within the European banking sector. It is necessary, when assessing the reallocation of risks related to holding investments which require the use of subcustodians, to take account of what is practical and what the consequences might be at a systemic level.

Current industry best practice is for the Depositary to accept liability in most instances for negligence by their sub-custodians in performing their sub-custodian responsibilities. An exception to this rule would be where the Depositary's ability to require that securities be held in its network is limited for valid investment reasons, or where there are special circumstances prevailing in a given market in which the fund wishes to invest. Examples of exceptions include:

Cases where (as is the occasional practice for some funds in the United Kingdom and Ireland) different parties perform the Depositary oversight and custodian role. In these cases, the Depositary appoints a custodian, and best practice is for that custodian to accept liability for its sub-custodians' negligence in performing their sub-custodian services.

Cases where assets are held with an agent of the UCITS fund, as the selection criteria for the appointment are the responsibility of the Manager.

Markets where, for investment reasons, it is not practicable to hold assets at a sub-custodian selected by the Depositary (such as is the case with Chinese A share classes) and;

Markets involving special risks which are disclosed to investors, as is the process recognised in Ireland.

In cases where exceptions to liability for negligence by sub-custodians apply, the Depositary would remain liable for direct damages incurred by the fund as a result of its failure to properly perform its responsibilities under the UCITS Directive.

The risks described in **'b) Improper performance of the safe-keeping duties for assets which cannot be held in custody'** are not correctly identified. According to the Consultation Paper, taking account of the fact that certain assets (such as OTC derivative contracts) cannot be safe-kept by the UCITS Depositary, "the risk is that no appropriate entity has a global view over the fund's assets so that false assumptions can be made regarding the real scope of the fund's portfolio." In fact, the UCITS Manager has been allocated the responsibility to maintain the accounts of the UCITS fund by Annex II of Directive 85/611/EEC. One of their tasks, embodied within Directive 85/611/EEC, is to ensure that valuation of OTC derivatives (which may be either assets or liabilities) takes place in a controlled and prudent manner (and reference should be had to the Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities).

In many countries, the accounting function has been delegated by the Manager to a specialist third party administrator. There are, therefore, mechanisms to establish the unit price of a UCITS fund. The role of the UCITS Depositary is oversight of this process with a minimum requirement to undertake sample testing of unit prices; not to supplant the obligations of the Manager.

As the Consultation Paper correctly notes, there are varying requirements at the national level for the UCITS Depositary to oversee the process of calculation of unit prices. We do not believe that the interests of investors would be served by requiring the UCITS Depositary to duplicate the efforts of the Manager or third party administrator.

The risks described in **'c) Improper performance of supervisory duties'** are not correctly identified. The example given by the Consultation Paper is the risk "where the fund's portfolio is mis-valued, leading to the mis-calculation of the value at which shares and units are issued and redeemed." As noted above, the primary responsibility for calculating the unit price of a UCITS fund has been assigned to the Manager (which may rely upon the assistance of a specialist third party administrator). If the UCITS Depositary improperly performs its supervisory duty, this would not be the cause of the miscalculation of the unit price of the UCITS fund, and primary responsibility would rest with the Manager for the failure to carry out its own function. The liability of the UCITS Depositary towards investors would be established by the application of national law, based upon the standard of "improper performance", if a causal link can be established between the performance and any loss incurred by the investors.

There are of course several other risks affecting UCITS and for which the Manager must bear responsibility as these are related to the investment decision making process, inter alia: Geopolitical risk, Country risk and CSD risk (use of which is not at the discretion of the Depositary)

***Question 11) Do you foresee other situations where a risk associated with improper performance of the depositary duties might materialise?***

No.

**Question 12) Do you agree that safeguards against the risk associated with the improper performance of depositary duties, such as requiring that UCITS assets be segregated from the depositary's and sub-custodian's assets, should be introduced?**

Yes, As noted in our response to question 10, it is already established practice to segregate client assets. It is worth noting that segregation of cash does not occur. All cash held by financial institutions is generally unsecured and subject to counterparty insolvency risk in the normal way.

## **2. Liability regime: Unconditional performance v obligation of means**

**Question 13) Do you agree there should be a general clarification of the liability regime applicable to the UCITS depositary in cases of improper performance of custody duties?**

Yes. Please note our response to Question 7 on the clarification of supervisory duties. As with the safe-keeping and supervisory duties, we believe that a clarification of the liability regime will enhance consistency across EU member states but such a regime should be based on the supervision and monitoring requirements advocated in our response to Question 7. .

**Question 14) What adjustments to the liability regime associated to the custody duties of the UCITS depositary would be appropriate and under what conditions?**

We propose adjustments in line with the positions taken in our "Position Paper on Fund Depositaries" dated 15 July 2009, the relevant points of which are listed hereafter.

In our view, the liability of a Fund Depositary under UCITS is already sufficiently clear and adequate to protect the legitimate interests of investors in UCITS funds. Recent events have highlighted the need for investor protection to be assured through proper enforcement of the existing obligations and liability of a Fund Depositary, but have not demonstrated inherent problems with UCITS. We also believe, however, that changes to UCITS to clarify the minimum requirements for a Fund Depositary, in the selection and monitoring of sub-custodians, would be beneficial to reassure investors and ensure that the duties of the Fund Depositary are consistently understood and discharged throughout Europe. The principles we would suggest, which are already expressed in the legislation and regulations of some EU member states, include the following:

1. The Fund Depositary should be responsible for using reasonable care and diligence when choosing and instructing the sub-custodians, as well as for taking reasonable care to monitor that they remain suitable;
2. The standard of reasonable care should be established by the prevailing industry practice regarding the skills, care and diligence expected of a Fund Depositary, as qualified by local legislation or regulation;
3. When appointing a sub-custodian, the due diligence of a Fund Depositary should include taking reasonable steps to provide for the segregation of the assets of the UCITS funds it supports from the assets of the sub-custodian, in the event of the failure of the sub-custodian (as well as from the assets of the Fund Depositary itself, in the event of the failure of the Fund Depositary);
4. In the event of the failure of a sub-custodian, the Fund Depositary should be required to take reasonable steps towards the expeditious delivery of the assets of the UCITS funds it supports to another sub-custodian. There should not be a presumption that the Fund Depositary owes an obligation towards a UCITS fund to return

assets, which are detained due to administrative procedures related to the insolvency of the sub-custodian, immediately and without regard to the operation of local laws in the country where the insolvent sub-custodian is located; which is part of the investment risk associated with investment in a particular market; and

5. Fair disclosure of the risks of investing in markets, including the risk of failure of a securities intermediary in a particular market, should be provided to investors in UCITS funds by the fund manager.

A burden on the Fund Depositary to take stricter liability, particularly for the insolvency of its sub-custodians, would be expected to have negative effects, including without limitation:

1. substantially higher costs being charged by the Fund Depositary for rendering its services, which will have to be borne by the funds. This could reduce the benefits to investors of the UCITS scheme; and, in a market where positive returns are a challenge to obtain, could make them less attractive to investors;
2. reducing the number of markets, particularly emerging markets, which Fund Depositories are willing to support; thereby reducing the types of collective investment schemes which are available to investors; and
3. forcing Fund Depositories to change their eligibility criteria for sub-custodians, reducing competition for sub-custody business in local markets and allowing top-tier sub-custodians to charge a premium, which would find its way into fund expenses through the charges of the Fund Depositary.

Reversal of the burden of proof, in respect of lost securities, is inconsistent with the legal principle that a person's responsibility ordinarily must be established on the basis of evidence showing fault. There is nothing to indicate that, in the cases which are being brought against Fund Depositories on the basis of the Madoff or Lehman situations, there is any deficiency in the current legal arrangements which needs to be corrected through the imposition of this measure. The legal systems of the EU member states are quite capable of assessing liability and awarding compensation, in appropriate cases, without establishing new legal rules which could be subject to differing interpretations in different EU member states.

Requiring Fund Depositories to verify the ownership of certain fund assets is impractical and miscasts the responsibilities of the manager and the Fund Depositary. Ownership of property is generally determined by the law of the place where the property is located. Requiring the Fund Depositary to verify ownership of every asset in every market would require legal reviews by market and asset, which would be unduly complicated and costly, with the burden being borne by the fund investors.

## **B. Liability regime of depositaries in cases of delegation**

- 1. The Depositary liability upon delegating its functions to a third party*
- 2. Conditions applicable in case of delegation of the depositary duties*

***Question 15) Do you agree that the conditions upon which the UCITS depositary shall be able to delegate its duties to a third party should be clarified?***

Yes. Clarification of the responsibilities of the Depositary in respect of safe-keeping, which is delegated to a global custodian or individual subcustodians, should be codified. The delegation issue is very complex and should always be approached with a view to true harmonisation. In no event should substantive discrepancies (such as an unqualified duty of immediate restitution of assets which prevails in certain jurisdictions vs a duty of reasonable care and diligence in the selection and monitoring of subcustodians in other jurisdictions) be allowed to be introduced in the context of laying down conditions upon which a depositary may be able to delegate certain duties.

We have set out at Appendix 1 our recommendations for such standards.

***Question 16) Under which conditions should the depositary be allowed to delegate the performance of its duties to a third party?***

We would like to reiterate the principles laid down in our "Position Paper on Fund Depositaries" dated 15 July 2009, the relevant points of which are listed hereafter

Restrictions on the ability of Fund Depositaries to delegate functions to persons which are not also Fund Depositaries will reduce the possibilities for Fund Depositaries to rely upon specialist units within their corporate groups, or otherwise, to enhance the capabilities of the Fund Depositary. The proposal in the AIFM Directive, in this respect, is unclear and should be reconsidered.

***Question 17) Do you agree that the depositary should be subject to additional on-going due diligence requirements when delegating the performance of its duties to a third party?***

Yes. Please note our response to Question 1. If delegating safe-keeping to a global custodian or subcustodian, a Depositary should be subject to ongoing due diligence.

### C. Default (bankruptcy)

***Question 18) Do you share the Commission services approach to reviewing the ICSD, to allow UCITS to benefit from a compensation scheme where the depositary defaults?***

No. Market risk should not be covered by a compensation scheme. A compensation scheme will result in higher cost and lower returns for investors. Funds are investment products and should carry appropriate risk disclosures. In that sense, funds are different from deposits.

***Question 19) Do you agree that UCITS holders should also benefit from compensation if their custodian defaults and these assets are lost?***

No. Most custodised assets are off balance sheet items and will usually not be impacted by the custodian's default (they are "ring fenced"). Compensation would therefore equally require an insurance, which will ultimately have to be borne by the investor.

### III. ORGANISATIONAL REQUIREMENTS

**Question 20) Do you agree that the general organisation requirements that are applicable to a UCITS depositary should be clarified?**

No. Organisational requirements should be left to national rules. We note that credit institutions are already subject to certain organisational requirements.

**Question 21) If so, to what extent?**

Consistency between UCITS and MiFID should be sought, wherever appropriate. That consistency should aim to reduce overall regulatory complexity.

**Question 22) Do you agree that requirements on conflicts of interest applicable to UCITS depositaries should be clarified?**

Yes.

**Question 23) If so, to what extent?**

The requirements on conflicts of interest should harmonize the organisational requirements set by national regulations. The requirements should also become equivalent across the EU, regardless of the institution eligible to conduct depositary business.

#### IV. ELIGIBLE DEPOSITARY INSTITUTIONS

##### A. The type of eligible institution

**Question 24) Do you agree that there is a need for clarifying the type of institutions that should be eligible to act as UCITS depositaries?**

Yes

**Question 25) Do you agree that only institutions subject to the CRD should be eligible to act as UCITS depositaries?**

No. At present, the Depositary function is performed by entities which are authorised under national law. While there is clearly an argument to be made in favour of harmonising the requirements for Depositaries (by e.g. requiring such institutions to be subject to the CRD) there is no evidence to suggest that one form of an entity should be approved to the exclusion of all others.

For example, in jurisdictions where the Depositary function is usually fulfilled by trust companies (which are not credit institutions subject to the CRD), UCITS should continue to allow national laws to provide for them to undertake the function, provided that the role, responsibilities and liabilities of Depositaries are defined consistently, irrespective of whether the entity is subject to CRD or not.

The precise type of legal entity (investment firm, broker-dealer, trust company) does not matter, as long as the role, responsibilities and liabilities of Depositaries, and governance structure are defined consistently. A functional approach seems highly desirable in this context.

**Question 26) If not, which types of institutions should be eligible to act as UCITS depositaries, and why?**

It is recommended that the requirements include institutions subject to the CRD and be extended to bodies which are guaranteed by credit institutions or have sufficient substance through other capital or regulatory approval requirements to be able to perform the depositary function. This approach would promote competition for depositary services, while preserving models of depositaries which are not credit institutions but have long demonstrated their ability to discharge the depositary functions to a high standard.

## V. SUPERVISION ISSUES:

### A. Supervision by auditors

***Question 27) Do you agree that additional auditing requirements should be imposed, such as an annual certification of the depositary's accounts by independent auditors?***

No. UCITS funds are already subject to annual audits, and there would be no benefit in adding another audit to the process.

## B. Supervision by national regulators

***Question 28) Do you agree that UCITS depositaries should be subject to a specific 'depository' approval by national regulators?***

We would welcome harmonisation of the Depository approval process, provided that it does not result in the imposition of eligibility criteria which will cause unnecessary disruption to the European depository industry. For example, the proposed AIFM Directive requires that depositaries be credit institutions; i.e., institutions subject to the CRD. This would negatively impact many well-established Depositaries in, for example, Ireland and the United Kingdom. It is recommended that requirements include institutions subject to the CRD and be extended to bodies that are guaranteed by credit institutions or have sufficient substance through other capital and regulatory approval requirements.

***Question 29) Do you believe that there is need to promote further harmonisation of the supervision and cooperation by European regulators of depository activities? What are your views on the creation of an EU passport for UCITS depositaries?***

We endorse the creation of a EU passport for UCITS depositaries. Most of the questions raised in this consultation paper prompt further clarification of the role of the depository. This clarification would reduce the scope for differences when transposing the directive into national legislation and therefore create an equivalence in all EU member states. An equivalence of duties across member states paves the way for a passporting of the depository function.

Several of the considered measures discussed in this consultation paper will introduce additional cost into the depository process. This cost will ultimately be borne by investors in the shape of lower returns on their savings. A depository passport would counteract some of the implied cost increases as providers of depository services would generate pan-European scale. A depository passport would also break down one of the last national barriers in the fund servicing industry.

## VI. OTHER INVESTORS PROTECTION ISSUES

### A. Calculation of the net asset value of the UCITS shares and units by an independent valuator

**Question 30) As far as the UCITS portfolio and UCITS units or shares are concerned, do you agree that their value should be assessed by an independent valuator?**

No. The calculation of the UCITS' net asset value is one of the key functions and responsibilities of the fund manager today. The UCITS framework should be flexible enough to allow fund managers to continue to perform this function, or to subcontract the function to a specialist third party administrator, as may be appropriate in the circumstances.

The Depositary's role should not preclude it from assuming the role of an independent valuator provided that in view of the oversight role of the depositary, the appropriate segregation of functions is required within the Depositary organisation. There should not be a requirement that the manager's (or its third party administrator's) valuation should not be duplicated by the Depositary, as it would be inefficient and raise costs which will ultimately be borne by investors.

**Question 31) If so, what should be the applicable conditions for an entity to be eligible to act as an UCITS Valuator?**

N/A

**SUB-CUSTODIAN SELECTION PROCESS**

A global custodian is responsible to appropriately select and monitor sub-custodian banks that provide settlement and custody services for client investments globally. In support of this, a global custodian should employ a robust selection and monitoring process that covers both the core competence and the financial strength of the sub-custodian banks. Prior to the appointment of a sub-custodian, a detailed review should be conducted to ensure that the bank can meet the required standards. There are many factors which should be considered in assessing whether a sub-custodian is equipped to support a global custodian. The following are key factors in the evaluation:

- Financial strength
- Management and the operational infrastructure assessment
- Understanding and accountability for compliance with regulatory policies
- Staffing and expertise of the custody operation
- Transaction and safekeeping volume capacity
- Sophistication of technology/telecommunications
- Contingency plans
- Internal control, and related risk management infrastructure
- Results of external/internal audits
- A SAS70 or equivalent third party review of the custody operation
- Insurance coverage
- Vault capacity and security (in markets where physical certificates are held)
- External linkages to settlement and registration processes, depositaries, exchanges and clearing entities
- Income processing, corporate actions and proxy voting services and capabilities
- Links with the institution's Foreign Exchange and Treasury units
- Assessment of value-added products (investment vehicles, lending, other contractual services)
- Tax related expertise
- Business strategy/commitment (short-term and long-term)
- Pricing
- Contractual arrangements

Determination of financial strength is critical and a global custodian will make a determination that the sub-custodian banks have the financial strength to provide reasonable care for fund assets. The following items may be reviewed in support of this analysis:

- Profitability, including return on assets (ROA) and return on equity (ROE)
- Capitalization, including Tier 1 capital ratio
- Asset Quality
- Liquidity and Funding
- Management (structure and experience)
- Public Debt Rating (if available)
- Local accounting standards and regulatory environment
- Credit/Economic research
- Country/Sub-custodian risk issues
- Legal Counsel review of sub-custodian agreement
- Parental Guarantees (if applicable)
- Local Government Support