COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Date: 19 April 2010
Ref.: CESR/09-990

FEEDBACK STATEMENT

CESR's technical advice to the European Commission on the level 2 measures related to the UCITS management company passport

Background

1. In March 2007, the European Commission announced a series of targeted enhancements to the UCITS Directive. Following further work and consultation, the Commission adopted a proposal for the revised UCITS Directive on 16 July 2008. The European Parliament (at its plenary session of 13 January 2009) and the Council (COREPER meeting of 17 December 2008) approved, in identical terms, a compromise text of a proposal for a Directive containing amendments to the UCITS Directive (85/611/EEC). The Directive (2009/65/EC) was adopted by the Council on 22 June 2009 and published in the Official Journal on 17 November.

2. On the same day as the adoption by the Commission of its Directive proposal (16 July 2008), the Commission requested CESR's technical advice on the conditions that are needed to ensure that a management company passport is consistent with the principle that investors in funds that are managed on a cross-border basis should not be exposed to additional legal and operational risks, or lower standards of supervision than investors in domestically managed UCITS. Following a call for evidence, an open hearing and a short public consultation, CESR delivered its advice to the Commission on 30 October 2008 (Ref. CESR/08-867).

3. In light of the approval of the compromise text by the European Parliament and the Council as outlined above, the Commission prepared a Provisional request to CESR for technical advice on possible implementing measures concerning the future UCITS IV Directive ('the mandate')[1]. The mandate was split into three parts as set out below.

   Part I – measures related to the management company passport

   This part includes obligatory implementing measures which in some cases must be adopted by the European Commission by 1 July 2010. The following topics are covered: requirements on organisational arrangements, conflicts of interest and rules of conduct for management companies; risk management; additional measures to be taken by depositaries; and issues related to supervisory co-operation. The deadline for delivery of CESR's advice on Part I was 30 October 2009.

   Part II – measures related to key investor information

   This part covers implementing measures on the form and content of key investor information (KII) disclosures for UCITS. The request takes account of the earlier request on KII sent to CESR in April 2007, in response to which CESR submitted a first set of advice in February 2008. The deadline for delivery of CESR's advice on Part II was 30 October 2009.

   Part III – measures related to fund mergers, master-feeder structures and the notification procedure

   The Commission is not under a legal obligation to adopt implementing measures in these areas. As such, the Commission encouraged CESR to focus in a first stage on the advice on Parts I and II above. Regarding Part III, the Commission invited CESR to reflect on the best way to organise its work in such a way that all necessary level 2 measures are adopted in time for them to be implemented by Member States within the timeframe imposed by the level 1 Directive.

4. Following receipt of the mandate on 13 February 2009, CESR began work to develop its response in view of the deadline for submission to the Commission of 30 October 2009. A call

[1] http://ec.europa.eu/internal_market/investment/docs/legal_texts/ta_mandate_en.pdf

for evidence was published on 17 February 2009 (Ref. CESR/09-179), to which CESR received 30 responses. Taking into account responses to the call for evidence and following intensive preparatory work within CESR, a consultation paper was published on 8 July 2009 (Ref. CESR/09-624) to which 26 responses were received. These responses, which are available on CESR's website[2], were taken into account in the preparation of CESR's final advice (Ref. CESR/09-963), which was submitted to the Commission on 28 October 2009. CESR's advice was prepared by the Investment Management Expert Group, which is chaired by Mr Lamberto Cardia, Chairman of the Italian securities regulator, the Commissione Nazionale per le Società e la Borsa (CONSOB).

5. CESR's advice under Part II of the mandate (Request for technical advice on the level 2 measures related to the key investor information) was submitted to the Commission in October 2009 (Ref. CESR/09-949). CESR's advice on Part III of the mandate (Request for technical advice on the level 2 measures related to fund mergers, master-feeder structures and notification procedure), meanwhile, was delivered to the Commission on 22 December 2009 (Ref. CESR/09-1186).

6. CESR published a separate consultation paper on 15 June 2009 on risk measurement for the purposes of calculation of UCITS' global exposure (Ref. CESR/09-489). The issues covered under that consultation resulted in the advice set out in Chapter II of Section IV of document Ref. CESR/09-963. Feedback on that part of the advice will be included in a separate feedback statement that will accompany the level 3 guidelines on risk measurement on which CESR has been working in recent months.

[2] Call for evidence (Ref. CESR/09-179): http://www.cesr.eu/index.php?page=responses&id=132
Consultation (Ref. CESR/09-624): http://www.cesr.eu/index.php?page=responses&id=144

General remarks

Generally, CESR's proposals were welcomed by respondents. In the consultation paper, CESR invited respondents to estimate the possible additional costs incurred by CESR's proposals. All the respondents agreed on the principle that, in most cases, the proposed measures would lead to additional costs but no respondents were able to quantify them. The responses also show that the impact will differ across Member States (MS). One respondent mentioned that a number of MS already applied policies similar to the CESR proposals; in these MS the cost impact of the proposals is likely to be minimal.

Concerning Section V on supervisory co-operation, no specific comments were made by the respondents.

Section I: Implementing measures on organisational requirements and conflicts of interest for management companies.

General approach

Globally, respondents agreed with the general approach proposed by CESR. One respondent welcomed that CESR had taken into account in its advice the principle of proportionality. Respondents also agreed with the approach to treat the MiFID level 2 provisions as the primary regulatory model for the purpose of CESR's advice although they considered it important that the specificities of the collective management business should be taken into account. One respondent stressed that the adjustment to the specificities of the collective management business should be done by adjusting relevant MiFID provisions and not by adding new functions or duties.

Chapter 1: Organisational requirements

1. Impact of the proposed approach

Some respondents did not expect additional costs due to the alignment of organisational requirements for UCITS management companies with the relevant MiFID requirements since their national legislation has already introduced a regulation aligned (partially or fully) with MiFID requirements.

One respondent believed that the potential for extra costs would depend on whether MiFID had already been applied to management companies at a national level, and in which way. In some areas such as recordkeeping or transaction reporting, there could be significantly high costs as the requirements would be entirely new. The same respondent appreciated the fact that CESR was had sought input on costs but noted the difficulty in providing estimates.

Almost all respondents recognized that the alignment with MiFID would create a level playing field for comparable activities.

2. Sound organisational procedures and arrangements for management companies (Box 1)

Respondents broadly agreed with the CESR's proposals on organisational procedures and arrangements. One respondent felt that the proposals reflected efficient organisational standards that were already in place in the fund industry.

One respondent suggested the deletion of the item 1e) on the basis that it did not reflect a MiFID requirement. Another sought clarification on this provision and on the meaning of 'any other third

party which performs activities on behalf of the management company'. Another respondent agreed and highlighted the fact that the management company may not be aware of all distributors.

One responded suggested that paragraph 1 d) be amended and, more specifically, that the word 'employ' be replaced by 'have available' as it might be possible to acquire the necessary skills and knowledge through delegation without directly employing the people.

One respondent sought confirmation of its understanding that CESR's proposals would not have a significant impact on the delegation by management companies of functions to specialist third party providers. The same respondent took the view that in case of delegation, management companies should not be subject to all the criteria set out in Box 1 but merely entrusted with a duty of oversight.

CESR took the view that the provisions set out for consultation in Box 1 were sufficiently clear so as not to require clarification or amendment. In relation to delegation, CESR has added some text to paragraph 10 of the 'General approach' in this section of the advice in order to clarify that the management company may take into account in its due diligence process the fact that the third party to whom activities are delegated is itself subject to MiFID.

3. Internal control mechanisms: responsibility of senior management, compliance, internal audit and complaints handling

a. Responsibility of senior management (Box 2)

Most respondents agreed with CESR's proposals on the responsibility of senior management of management companies.

In light of the generally positive feedback received on its proposals in this area, CESR did not make any changes to the version published for consultation.

b. Remuneration policy (Box 3)

Several respondents agreed with CESR's proposals in their entirety.

A number of respondents felt each company should be free to decide the extent to which the remuneration policy should be internally transparent. Another respondent questioned the meaning of this concept; they felt it should be interpreted as a requirement that the documented policy be available to all employees but not as an obligation to provide any further details of how the policy had been implemented in practice.

Two respondents would have preferred the establishment of a cross-sectoral regime covering banks, investment banks, intermediaries, insurers etc) rather than focusing on UCITS management companies alone.

One respondent stressed that the recent revisions to the Capital Requirements Directive set out the framework for investment managers' remuneration policies that there were a number of inconsistencies between the revised CRD and the CESR proposals. One such inconsistency was that the policy should be reviewed 'regularly' under the CESR proposals while the CRD provision related to an annual review. Another respondent took a similar view, noting that CESR should take into

account the issues raised during the development of the CRD when establishing remuneration requirements for management companies.

One respondent agreed with CESR's proposals on the remuneration policy but only in so far as they would apply to senior management. The same respondent also sought clarification that the remuneration policy should be made available on request to the UCITS only when the latter is an investment company managed by the management company.

Extension of the requirements set out above in relation to senior management to all employees of UCITS management companies?

Respondents broadly disagreed with this proposal on the basis that it was disproportionate and should only apply to staff whose activities materially impact the risk profile of the management company. One respondent was supportive provided the requirements did not extend to any delegates.

In developing its advice on the remuneration policy, CESR paid close attention to the Recommendation of the European Commission on remuneration policies in the financial services sector of 30 April 2009. CESR considered that similar key principles regarding the remuneration of the staff whose activities materially impact the risk profile of the UCITS managed by the management company should be applied to the management company. It is a matter for the European Commission to decide whether and how best to introduce a cross-sectoral approach to remuneration beyond the Recommendation. Regarding the scope of the requirements, CESR deems it appropriate to apply them to the staff whose activities materially impact the risk profile of the UCITS managed by the management company, including the senior management. This is an approach which is both appropriately targeted and implies a sufficiently high level of responsibility on senior management.

In light of respondents' comments, CESR amended the requirement regarding review of the remuneration policy so that it should now be done on an annual basis.

Regarding the applicability of certain requirements to the different forms of UCITS, CESR has made clear in the Introduction of its advice (see paragraph 4 under 'General approach') that the requirements in the advice should be considered having in mind that a UCITS may be constituted under different forms.

c. Permanent compliance function (Box 4)

Respondents broadly agreed with CESR's proposals.

One respondent felt that the responsibility of the compliance function for ensuring compliance with the UCITS regime should be limited to the oversight of effectiveness of applicable policies and procedures and clearly distinguished from the management companies' operation functions.

One respondent believed that the obligation to put in place procedures designed 'to detect any risk of failure by the management company to comply with its obligations' would place an unrealistic burden on the internal controls as such systems could do no more than provide reasonable assurance.

One respondent agreed with the proposals but requested that points 34 to 36 of the explanatory text be moved to Box 4.

In light of the broadly supportive feedback from respondents, CESR did not make any changes to the advice published for consultation. CESR's advice is designed to put in place an appropriate

framework for UCITS management companies which takes due account of the existing level 2 requirements under MiFID. CESR believes that the principle of proportionality is sufficiently reflected in the explanatory text.

d. Internal audit (Box 5)

Most respondents agreed with CESR's proposal on management companies' internal audit arrangements.

One respondent agreed with the proposals but reiterated its view that where the management company makes significant use of delegation, the management company should only be required to make sure that the delegatee has an internal audit function in place.

One respondent sought confirmation that an internal audit function is mot mandatory in all cases, and clarification on how to assess the 'appropriateness' and 'proportionality' tests.

One respondent disagreed with the requirement in item 1 c) that internal audit must 'verify compliance with those recommendations'.

In light of the broadly supportive feedback to CESR's proposals, no changes were made to the version published for consultation.

e. Complaints handling (Box 6)

Several respondents agreed with CESR's proposal. Two respondents specifically noted the value of the proposals from the perspective of investor protection but felt the requirements would be a burden for management companies.

Several respondents suggested that the language requirement should be limited to the official language(s) of the country(ies) where the management company actually chooses to do business in order to avoid requiring that complaints in any EU language be accepted. They noted that this would be in line with Art.15 of the UCITS Directive and that neither MiFID nor UCITS required the establishment of a 'complaints handling policy' in terms of formal documentation of procedures.

One respondent believed that paragraph 3 should be removed because it went beyond its MiFID equivalent.

One respondent was of the view that it would not be feasible to maintain a record of each complaint due to the use of third-party distribution networks and the fact that complaints are usually addressed to distributors.

One respondent felt that it should be possible to establish a complaints-handling service at group level.

CESR took note of the comments made by respondents in relation to the proposed requirements on complaints handling. In order to allow sufficient flexibility regarding the organisational arrangements to be put in place, CESR modified the wording in the box so that management companies are required to 'ensure' recording of complaints and that proper measures have been taken. On the question of language, some additional text has been added to the Explanatory Text to clarify the appropriate interpretation of the requirement i.e. that an investor should be allowed to file complaints in an official language of a Member State where the UCITS is authorised or notified.

4. Personal transaction (Box 7)

Globally, respondents agreed with CESR's proposals on personal transactions but some had comments.

One respondent thought that item b) (ii) ('*any person…involved in the management of that undertaking*') was too broad and needed to be defined.

One respondent believed that the term 'person with whom he has a family relationship' also needed clarification.

One respondent took the view that where activities are delegated to a firm subject to MiFID, the management company can presume that the rules on personal transactions are observed. Where the delegation is to an entity in a non-equivalent jurisdiction outside of the EU, the management company should carry out appropriate due diligence.

One respondent sought clarification on situations in which individuals involved in the management of the UCITS invest their own money in the fund.

To take account of the request for clarification of the term 'person with whom he has a family relationship', CESR has added the following more detailed definition to the Glossary section:

'A person with whom a relevant person has a family relationship means any of the following:
- the spouse of the relevant person or any partner of that person considered by the national law as equivalent to a spouse;
- a dependant child or stepchild of the relevant person;
- any other relative of the relevant person who has shared the same household as the person for at least one year on the date of the personal transaction.'

5. Electronic data processing and recordkeeping requirements (Box 8)

Several respondents agreed with the proposal, in some cases due to their broad equivalence to the relevant provisions in MiFID, while noting that recordkeeping duties can be performed by depositaries in some cases. A suggestion was made that the content of the recording should include a specific identification of the investor and the relevant money. Two respondents saw merit in establishing a more detailed process as well as clarifying the responsibility regarding the anti-money laundering requirement.

One respondent supported the requirement to retain records for at least 5 years but felt that the ability of the competent authority, in exceptional circumstances, to require retention for a longer period 'as justified by the nature of the instrument or portfolio transaction' could cause difficulties for firms.

One respondent sought clarification on the 'recording of subscription and redemption orders', particularly on which orders would need to be recorded.

One respondent disagreed with paragraph 1)h) on the basis that this requirement went beyond the MiFID provisions on record-keeping and was of no discernible value to the competent authorities. The same respondent objected to the provisions on recording of subscription and redemption orders.

Two respondents disagreed with paragraph 57 of the explanatory text, which they found unclear and likely to breach confidentiality obligations towards clients, as well as potentially giving rise to data protection issues.

One respondent understood Box 8 as concerning investment management rather than the administration of UCITS, the latter being subject to the rules of the home MS. They expressed

broad agreement with the proposals but highlighted the situation of investment managers outside of the EU not necessarily being subject to the same standards of record-keeping; in such cases, it might create problems in relation to the recovery of certain data.

One respondent felt that the list of information in the advice should be exhaustive rather than indicative.

Regarding the recording of subscription and redemption orders, one respondent felt the proposed requirement would be impossible to implement as management companies were often not aware of the identity of the persons receiving the order from the unitholder; in the same vein, one respondent felt that record keeping could be carried out in cases of direct sales but not intermediated sales. On a similar point, another respondent questioned the feasibility of acquiring the information set out in the requirements when omnibus accounts are used, and called for greater harmonisation on the use of such accounts.

CESR has amended the text in Box 8 to take account of the comments relating to the possible role of the depositary in relation to record keeping; the duty on the management company is now to 'ensure' that the relevant records are kept.

CESR has noted the comments made in relation to paragraph 1h) of the Box but is of the view that this is an appropriate element of information for record-keeping purposes.

CESR saw value in clarifying which unitholder was being referred to in this context – the word 'legal' has been added to take account of the existence of nominee structures. CESR has also clarified the content of the recording by elaborating on the provisions in paragraph 2(iii) under 'Recording of subscription and redemption and orders'.

In order to respond to comments on the lack of clarity in paragraph 57 of the Explanatory Text, the wording has been revised to give a more general meaning (the reference to 'IT system' has also been removed).

The wording in paragraph 58 of the Explanatory Text has been revised in order to ensure consistency with the changes made to the Box regarding the role played by depositaries. Additional text has been added in the same paragraph to take account of the difficulties identified by stakeholders in relation to centralising certain elements of information (such as the identity of the investor and the amount of fees paid directly by the investor to the intermediary).

6. Additional non-MiFID provisions: organisation principles of the UCITS accounting (Box 9)

Respondents broadly agreed with CESR's proposal but made some specific comments:

- Several respondents requested inclusion of provision stating that in some countries the accounting of UCITS is not performed by the management company but by the depositary.

- One respondent made a specific drafting suggestion for paragraph 1 on the basis that it seemed to require full segregation only for investment compartments but not for each UCITS: *'the accounting books of each UCITS and, if a UCITS has different investment compartments, each investment compartment should be fully segregated'.*

One respondent expressed broad agreement with CESR's proposals but called for additional text to be added to the box to make clear that accounting is an area for which the home MS of the UCITS

has responsibility. Another respondent felt that work should be done to harmonise the accounting principles for UCITS in order to allow greater comparability of funds.

Regarding the detailed requirements, one respondent agreed in general but felt that it should be possible to use more than one IT application, particularly in relation to share class accounting.

In the final advice, CESR took account of the above-mentioned comments in relation to the role of the depositary via the insertion of some text in paragraph 59. The request for clarification on the requirement for full segregation of each UCITS has been recognised by the addition of text to the same paragraph. It has also been made clear that the accounting is an area of responsibility of the home MS.

Finally, CESR wished to make clear that the proposals in the advice in relation to segregation were without prejudice to national rules on pooling, provided such rules were consistent with the UCITS Directive.

7. Additional non-MiFID provisions: implementation of investment strategies

Implementation of the general investment policy (Box 10)

There were mixed views among respondents on CESR's proposed advice on implementation of the general investment policy.

One respondent agreed felt it was important to specify that the senior management should approve only the 'general investment policy' of each fund and control that the policy is respected.

One respondent agreed with the proposals but sought further clarity on the difference between the general investment policy and the investment strategies.

One respondent disagreed with these proposals and felt it would be sufficient to rely on the requirements on risk control, compliance, internal audit in order to ensure that the UCITS assets are invested in accordance with the prospectus/fund rules.

One respondent argued that it would be more appropriate that the responsibility of the senior management be limited to organisational aspects of ensuring compliance with the 'general investment policy'.

One respondent disagreed with the proposal to include the definition of investment strategy under the competence of the collegial body holding the highest level of corporate responsibility.

One respondent agreed with the proposals while emphasising the importance of the requirements being proportionate to the nature and organisation of the management company. Another respondent took the view that the requirements went beyond senior management duties and that additional flexibility was needed.

One respondent took the view that the responsibility of senior management for implementation of the general investment policy is a legal responsibility that can be delegated. The same respondent felt that it would not be feasible in practice for senior management to perform the requirements set out in paragraph 2.

One respondent felt that the level of detail was not appropriate for level 2 measures. Another respondent was not convinced of the legal basis for such requirements.

On the issue of costs and benefits, one respondent supported the proposal but was of the view that it would be lead to a greater administrative burden and costs. Another felt that it was not possible to make any estimate of costs.

CESR felt it was important to go beyond the MiFID requirements in its advice with respect to implementation of the general investment policy. In particular, CESR saw merit in the level 2 provisions establishing that senior management of management companies should implement the general investment policies defined in the UCITS prospectus and/or their articles of incorporation or fund rules by approving the appropriate investment strategies for each managed UCITS. CESR notes that the mandate from the Commission requested that the advice cover in particular 'the organisational requirements a fund manager should put in place in order to define how investment decisions are made.'

8. Additional non-MiFID provisions: implementation of strategies for the exercise of voting rights (Box 11)

Respondents expressed mixed views on CESR's proposals in relation to implementation of strategies for the exercise of voting rights.

Several respondents believed that the updated summary description of these strategies should be available only to the interested investors. Another possibility identified was to publish the principles of the strategy in the prospectus. According to two respondents, management companies should be allowed to monitor only events they consider as significant.

One respondent disagreed with the proposed requirements as they felt that the existing rules were sufficient.

For one stakeholder, management companies should be granted more flexibility in interpreting the 'exclusive benefit of unitholders' by amending the wording of the paragraph 2)b) in the following manner: *'evaluate timing and modalities for the exercise of the votes* ***in accordance with*** *the investment objectives and policy of the relevant UCITS'*.

One respondent agreed that any exercise of voting rights must be in the best interests of unitholders but did not believe that an obligation to vote should be the subject of regulation in a UCITS context only. According to the same respondent, the most important task was to identify contentious issues and ensure that votes are carefully exercised in these cases, while recognising that in some markets it is not always practical to exercise votes.

One respondent disagreed with the introduction by CESR of rules related to the exercise of voting rights as they felt there was no legal basis in the level 1 text. In particular, the respondent felt that paragraphs 1 and 2 should be deleted because they are superfluous; and that the requirement in paragraph 3 should cover publication of a voting policy only, not a requirement to disclose the actual votes cast.

One respondent agreed with the proposals but saw merit in limiting the scope of the proposed provisions only to those UCITS for which such strategies may be relevant. The respondent suggested deleting paragraph 2)c) due to the fact that conflicts of interests arising from the exercise of voting rights should fall within the scope of the requirements on conflicts of interest as defined in Box 12 to 16 of CESR's consultation paper.

One respondent questioned the value of the proposed requirements and felt they should be sufficiently high level in order to allow flexibility. The same respondent pointed out the fact that voting rights might be cast in different ways depending on the investment objective of the fund. On a similar note, several respondents sought clarification that the proposals would not impose an

obligation to vote, as there was no such obligation in the UCITS Directive and, in any case, abstention might be the best choice for unitholders.

One respondent felt the proposed voting requirements were too broad and would undermine efforts to facilitate meaningful involvement by shareholders with regard to the underlying UCITS financial instruments.

One respondent questioned the legal basis for these measures.

Several respondents felt that the proposed requirements could lead to an administrative burden, especially for smaller management companies, but were not able to provide any estimates.

One trade association noted that its members already made available to investors summary information on their voting right policies. However, depending on the specific requirements introduced, the extension of such information to implementation aspects could generate additional costs.

CESR took note of calls from several stakeholders for clarification that the proposed requirements would not result in an obligation on UCITS management companies to exercise a vote in all cases. The revised text in paragraph 71 makes clear that a decision not to exercise voting rights in certain circumstances, also taking into account the investment policy of the UCITS, could be considered as acting for the exclusive benefit of unitholders. CESR also took on board the specific drafting suggestion above in relation to paragraph 2)b).

Chapter 2: Conflicts of interest

1. Impacts of the proposed approach

Respondents expressed mixed views in relation to the possible impact of the proposals. Some respondents felt that there would be additional costs and administrative burdens for management companies, without providing specific estimates; two trade associations made specific reference to the proposals on conflicts of interest, which they envisaged would impose considerable costs on any of their members not yet subject to MiFID provisions.

Two trade associations did not envisage additional costs as their members were already applying rules that were in line with MiFID provisions.

Regarding potential benefits, one respondent identified a reduction of distortions in sectoral regulation and a consistent set of rules for management companies.

2. Criteria for the identification of conflicts of interest (Box 12)

Respondents broadly agreed with CESR's proposals to the extent that they were consistent with the relevant MiFID provisions.

One trade association favoured more stringent wording on the scope of application of conflicts of interest requirements. Specifically, the respondent felt that the first sentence of Box 12, paragraph 1 should be aligned with the requirement in Box 13, paragraph 2)a) so as to require identification of conflicts of interest 'that arise in the course of providing **collective portfolio activities**'.

One trade association suggested deleting item 1)d) on the basis that this was superfluous. The same association was also concerned that paragraph 3 of Box 12 and paragraph 14 of the explanatory text might breach the principle of equal treatment of all unitholders.

One trade association was of the view that the MiFID requirements needed further adaptation to take account of the UCITS sphere. In particular, they felt that further guidance was needed on the relative priority to be applied to the fund as opposed to its individual unitholders in relation to conflicts of interest. Another trade association raised a point in the same context, noting that UCITS are managed depending on the individual interests of all investors.

One stakeholder called for specific reference to be made to Recital 24 of the MiFID L2 Directive (the notion that there must also be a possible disadvantage to a client for a conflict to arise).

CESR agreed with the suggestion to align the scope of the requirement in paragraph 1 of Box 12 with the requirement in paragraph 2)a) of Box 13; both provisions now refer to collective portfolio management activities.

CESR does not believe that the requirements in paragraph 3 of Box 12 or in the Explanatory Text are inconsistent with the principle of equal treatment of all unitholders. Rather, the provisions are designed to take account of the particular situation of direct distribution of UCITS by the management company and the additional potential conflicts that may arise in such circumstances.

3. Procedures for conflicts identification and management (Box 13)

Respondents broadly agreed with CESR's proposals on the identification and management of conflicts, subject to some specific comments.

Two stakeholders suggested that there was no need for a conflicts of interest policy per UCITS and that one per management company should be sufficient.

One respondent considered that the requirement in the second sentence of paragraph 17 of the explanatory text was too far-reaching and that it should be sufficient to demand identification of conflicts on the basis of specific portfolio management activities carried out by or on behalf of the management company.

One trade association believed paragraph 2)a) should be re-drafted as follows: 'the interests of the UCITS or one or more other clients or investors in the case of direct sale'.

CESR recognised the need to clarify the drafting in paragraph 2)a) and added a reference to 'in the case of direct distribution'. CESR has also taken into account the comments made in related to the need for one conflicts of interest policy per management company (rather than a policy for each UCITS) by calibrating the text in paragraph 17.

4. Independence of the persons managing conflicts (Box 14)

Respondents broadly agreed with CESR's proposals on the independence of the persons managing conflicts.

One respondent sought clarification on whether the function of managing conflicts could only be performed by the compliance officer.

One trade association made a similar proposal as for Box 13 i.e. the addition of the text 'in the case of direct sale' to paragraph 2)a).

One respondent ask for clarification on the meaning of 'revenues generated' in paragraph 2)c).

In line with the broad support expressed by stakeholders for its proposals, CESR has not made significant changes to the draft advice. However, CESR recognised the need to clarify the drafting in paragraph 2)a) and added a reference to 'in the case of direct distribution'

5. Records of collective management activities (Box 15)

Respondents broadly agreed with CESR's proposals on records of activities giving rise to conflicts of interest.

One respondent felt the requirement to 'regularly update' the record of the kinds of collective portfolio management activities carried out was unclear and not relevant. The requirement should be to keep the record up to date, leaving firms to determine how regularly and how frequently is necessary to achieve this.

CESR did not make any changes to the advice published for consultation. CESR is of the view that the requirement to 'regularly update' the record is sufficiently flexible to allow firms to determine an appropriate frequency for the update.

6. Management of non-neutralised conflicts (Box 16)

Two respondents expressed specific agreement with CESR's proposals.

One law firm, while supporting the proposals, felt it should be clarified that management companies in situations of non-neutralised conflicts would not be required to conduct a mail-out to existing unitholders.

One trade association, while supporting the proposals, thought that paragraph 28 of the explanatory text should be reworded in order to make clear that disclosure in periodic reports would be sufficient for compliance with the reporting duty stipulated in Box 16, paragraph 1, 2nd subparagraph. The same respondent also believed that the extension of standards for management of non-neutralised conflicts to individual portfolio management suggested in paragraph 31 of the explanatory text should be deleted as it contradicts and discriminates against UCITS management companies in comparison with MiFID companies authorised for the provisions of the same services.

One respondent believed that the senior management of a UCITS management company should be responsible for the management of all conflicts, including those that are 'non-neutralised'. Thus, a requirement to escalate such conflicts to the senior management seemed superfluous.

Almost all members of one trade association strongly disagreed with CESR's approach because it went beyond MiFID requirements for conflicts of interest. They felt unclear who the 'relevant unitholders' were and how a management company should discriminate between two different categories of unitholder.

One trade association found the overall principle acceptable but believed the advice dealt with the issues incorrectly. In particular, the damage of interests should be considered with regard to the UCITS that is managed; reference to the interests of the 'relevant unitholders' was wrong because a management company could not be expected to know their interests. Additionally, further clarification was needed on the details and explanations concerning the reporting obligation to 'investors' in case of non-neutralised conflicts.

One trade association suggested replacing the reference to the 'best interests' of the UCITS and paragraph 1 of box 16 with a reference to 'fair treatment'.

Four trade associations asked for the deletion of the requirement of reporting to investors on situations in which the management company is not able to neutralise a conflict of interest, as they felt this would go beyond MiFID (since the MiFID provision in question does not apply to management companies when providing individual portfolio management services). One of these associations felt that paragraph 31 of the explanatory text should be replaced by the MiFID provisions.

Two trade associations felt the reporting to investors of conflicts of interest in a durable medium should be satisfied by general disclosures in the UCITS' founding documents, and that the principle of collective professional management should be borne in mind.

CESR is convinced of the need to apply appropriate requirements on conflicts of interest to UCITS management companies, including in relation to disclosure of non-neutralised conflicts. CESR's advice makes a clear distinction between conflicts that might arise in relation to the management of the UCITS as a whole and the particular circumstances arising from direct distribution of units by the management company.

CESR recognised the need for additional clarification on the manner of the disclosure of non-neutralised conflicts in the context of direct distribution, hence the inclusion of the text 'by any appropriate durable medium' in paragraph 2 of the box. CESR has also clarified that 'ex ante' disclosure may not be the most appropriate most appropriate investor protection tool in connection with non-neutralised conflicts of interest arising from management of the UCITS.

Section II: Rules of conduct for management companies

Respondents broadly agreed with the approach taken in CESR's advice, namely to achieve as close an alignment as possible with the existing MiFID provisions.

One trade association called for inclusion of a definition of 'professional investor' and 'retail investor' on the basis of the MiFID definitions, but preferred 'investor' to 'client'.

CESR has added MiFID-based definitions of 'professional investor' and 'retail investor' to the Definitions section of its advice.

1. Provision of the service of collective portfolio management and due diligence requirements (Boxes 1 and 2)

Two respondents agreed with the proposals.

One respondent agreed with the principles in the draft advice but did not see any need for the proposed detailed rules.

Two respondents asked for a clarification on how the due diligence policies and procedures should be formulated. They also sought an explanation of the appropriate balance to be struck between the selected investments and the due diligence process.

One law firm supported the transparency obligation but sought clarification on the references to 'fair' and 'correct' pricing model.

One trade association had several comments:

- The paragraph 3 box 1 must be reworded: 'Without prejudice to specific national law requirements, management companies should **ensure that** fair, correct and transparent pricing models and valuation systems **are applied** to the UCITS they manage in order to comply with the duty to act in the best interest of unit-holders. Management companies should be able to demonstrate that the **UCITS portfolio have been accurately valued**'

- Prevention of undue costs (Box 1, paragraphs 4 and 2 of the explanatory text): the respondent strongly rejected the notion of requiring management companies to act in the best interest of investors when defining their own fees charged to the fund. In their opinion, the definition of charges is a purely commercial decision for a management company and must remain unhampered by regulatory intervention in order to allow for fair and dynamic competition.

- Detailed due diligence for each and underlying fund would result in a significant increase in costs at the fund of fund level, which would render these vehicles less attractive to investors. The requirement to keep records of due diligence assessment for every single investment decision would be very onerous.

One trade association was in broad agreement with the proposals but had several comments:

- Paragraph 3, Box 1: it was unclear to whom the management company should 'be able to demonstrate that they have accurately valued the UCITS portfolios'. According to the respondent, the obligation to demonstrate should be vis-a-vis the competent authority only.

- The scope of paragraph 4 is too broad.

- Paragraph 2 could be read as extending the management company's fiduciary duty to the setting of its own fees, which would lead in extreme cases to the prohibition of any profit.

- A high level of due diligence is appropriate but the record-keeping requirements in paragraph 4 of Box 2 should be reconsidered.

One trade association agreed with the proposals overall but had two comments:

- Paragraph 1, Box 1: 'undue treatment' should be replaced by 'undue preference'.

- Paragraph 3, Box 1: this duty should be owed to the regulator or to the depositary

One trade association raised the issue of how the general duty to act in the best interests of the client would be applied in cases of delegation (Box 2).

One trade association preferred to see the reference to national laws removed in order to foster harmonisation among Member States (Box 1).

One trade association proposed an amendment to the wording in paragraph 1 of Box 1 ('to the detriment of others' rather than 'over others'), in order to clarify that it would be possible, for example, to apply lower management fees to some unitholders depending on the volume of their investments. In Box 2, the same respondent felt that the requirement to 'ensure' liquidity was too strict given experience in the crisis.

One respondent felt the requirement in paragraph 4 of Box 2 regarding detailed quantitative and qualitative analysis prior to investment was inappropriate. Another respondent felt this requirement was not appropriate for management companies that did not provide discretionary investment management services to the UCITS. In such circumstances, the investment manager to whom such a function is delegated would typically carry out the necessary investment analysis, with the management company having an oversight role.

Box 1

CESR has taken into account the comments highlighting the potential role of the depositary in relation to the requirements referred to in paragraph 3. The requirement has been redrafted in order to allow sufficient flexibility regarding the entity that performs the pricing and valuation.

CESR has also clarified that the obligation to demonstrate accurate valuation is vis-a-vis the competent authority.

A drafting change has been made to paragraph 1 so that the reference is now to 'undue preference' rather than 'undue treatment'.

Box 2

CESR has carefully considered the comments made by respondents in relation to the draft advice in Box 2. CESR is of the view that its advice on due diligence is proportionate, as well as being highly relevant to the business of UCITS management companies. It is particularly important to make progress in this area taking into account the lessons from recent market events. Specifically in relation to the requirement in paragraph 4 concerning forecasts and analysis, CESR has deliberately taken a balanced approach by including 'where appropriate taking into account the nature of the foreseen investment'.

Impact on firms

Two respondents felt that the proposed requirements would create additional costs and administrative burdens on management companies, while one trade association did not envisage additional costs as similar requirements were already in place in their jurisdiction.

2. Direct sale

a. General approach (Box 3)

Three respondents agreed with the general approach.

One trade association agreed with the general approach but sought clarification on whether the definition of 'direct sale' includes only sales with solicitation or also sales without client solicitation. Two respondents felt that the term could be clarified, perhaps via inclusion of a formal definition in Box 3. Similarly, there was a suggestion from one trade association to refer to 'distribution' instead of 'sale'.

One trade association agreed with the general approach but believed that Box 3 should not make reference to Box 9, given that the application of rules on aggregation and allocation of trading orders to direct sale was not feasible. Three respondents disagreed with the extension of requirements on best execution (Boxes 7 and 8) on the basis that this was not appropriate to direct sale, or that the current rules on conflicts of interest were sufficient.

One trade association believed that the proposals would facilitate cross-border activities and create a more level playing field between different products and services.

Having considered the comments made on the concept of 'direct sale', CESR decided to amend the term to 'direct distribution'. CESR took the view that this was more easily understandable for stakeholders. CESR has also clarified that this is an activity that can be provided either at the initiative of an investor or by the management company without the investor taking such an initiative.

b. Appropriateness test and execution only (Box 4)

One trade association agreed with CESR's proposals.

One trade association was not convinced of the merits of applying the appropriateness test requirements to UCITS management companies, particularly where the management company sells only UCITS. On a similar note, another trade association felt the scope should be limited to retail investors.

One law firm disagreed with paragraph 8 as they felt it was disproportionate and made the regime unduly complex. A more straightforward approach would be not to apply the appropriateness requirements at all; rather, direct sales should be accompanied by a warning that no advice has been provided and that any relevant regulatory rules on advice, appropriateness or suitability have not been complied with.

One trade association agreed with the proposal but believed that CESR should state more clearly that sale by 'execution only' is possible.

In order to put in place a comprehensive and consistent regulatory framework regarding distribution of units in UCITS, CESR is of the view that it is necessary to apply equivalent requirements on the appropriateness test to UCITS management companies as already apply to MiFID firms performing the same activity. In CESR's view it is not justifiable, particularly from the perspective of investors, to have different set of regulatory requirements on UCITS management companies versus MiFID

firms in relation to distribution of UCITS. CESR has therefore confirmed its proposals in the final advice sent to the Commission.

c. Handling of subscription and redemption orders of investors (Box 5)

Three trade associations agreed with CESR's proposals.

Three respondents asked for clarification on Box 5 because they did not understand the meaning of the phrase 'in accordance with the relevant provisions of the fund rules or the instruments of incorporation and/or the prospectus'.

One trade association felt that Box 5 could be deleted as management companies are at all times bound by the applicable law and regulations, the fund rules or instruments of incorporation as well as the prospectus.

In CESR's view it is clear that investors' subscription and redemption orders must be handled in accordance with the relevant provisions of the fund rules/instruments of incorporation and the prospectus. This would mean, for example, that the UCITS may not apply a less favourable approach with regard to cut-off dates than is set out in the prospectus.

d. Reporting obligations in respect of execution of subscription and redemption orders (Box 6)

While one trade association agreed with CESR's proposals, several respondents took the view that CESR's proposals did not reflect market practice and went beyond the MiFID requirements. In particular, the requirements should be limited to retail investors and clarification should be given on what type of execution is envisaged (i.e. 'material' or 'legal'). One stakeholder called for alignment with the Distance Marketing Directive.

One trade association felt that points (a) and (b) of paragraph 1 should not apply where the confirmation notice would contain the same information as a confirmation sent promptly by a third party. Two associations sought clarification on which venue the requirement in paragraph 3(g) related to. Similarly, one association felt that paragraph 3(g) was not relevant for non-listed UCITS.

In light of comments made about the scope of application of the draft advice, CESR has amended paragraph 1)b) so that the requirement applies to retail investors only. CESR also recognised the potential difficulties caused by the reference to 'venue identification' in paragraph 3)g); this element of information has been deleted from the final advice.

3. Best execution

a. Direct execution of orders by the management company (Box 7)

Respondents broadly agreed with CESR's proposals on direct execution of orders by the management company but had comments on specific elements.

Several stakeholders believed that prior consent of a UCITS to the direct execution policy requested in Box 7, paragraph 3 was not feasible in case of common funds without legal personality. Such requirements should be restricted to UCITS in the form of investment companies.

One trade association believed that the requirements in paragraph 3 and in paragraph 6 should apply only to the regulator and/or depositary. The requirement in paragraph 5 for an 'annual' review by the management company went beyond MiFID requirements, which did not prescribe a specific frequency, and should be deleted.

One trade association suggested that the obligation to demonstrate the execution of orders in accordance with the policy should be to the governing body of the UCITS, given that the competent authority will in any event have the right of access to this information.

One law firm was not convinced of the added value of including information on best execution in a firm's disclosure documents to investors.

One trade association agreed with the proposals as the MiFID principles on best execution were already applied to UCITS management companies in their jurisdiction. However, the same respondent disagreed with the need to obtain 'prior consent of the UCITS' as set out in paragraph 3.

One respondent raised a number of concerns on CESR's proposals, including that the requirements were not appropriate for self-managed UCITS. They also sought clarification on which transactions would be excluded from the requirements on best execution. In addition, the respondent felt that the requirement for management companies to demonstrate compliance with the execution policy should not be subject to a full and independent audit. Another trade association had similar concerns on the basis that the management company is the client in the context of execution, so it should not itself be subject to the requirements.

One trade association requested that the same wording be used as under MiFID.

One respondent asked CESR to confirm that the reference in the heading in page 72 to 'direct execution of orders by the management company' meant that where a management company appoints a duly authorised investment manager to provide discretionary management services in respect of the UCITS, MiFID requirements in respect of best execution should not be imposed on the management company i.e. such requirements would in fact apply to the investment manager and the entity with which it places the order. The same respondent felt that the requirement in paragraph 33 of the explanatory text was unnecessary.

Impact

One respondent believed that CESR's proposals would facilitate cross-border activities and create a more level playing field between different products and services.

CESR notes the comments made by respondents regarding the potential inapplicability of certain elements of the Box, particularly paragraphs 3 (obtaining 'prior consent' and 6 (demonstration to the UCITS), in the context of contractual funds that have no legal personality. Some text has been added to paragraph 2 of the Introduction to take account of this.

CESR has also clarified that the obligation in paragraph 6 is to the relevant UCITS (i.e. neither the depositary nor the competent authority).

In the final advice, CESR has elaborated in the explanatory text on what should be considered an appropriate means of disclosing the execution policy to unitholders (see paragraph 33).

b. Placement of orders with other entities for execution (Box 8)

Respondents broadly agreed with CESR's proposals on the placement of orders with or transmission to other entities for execution.

One trade association agreed with the proposals but asked for clarification on paragraphs 3 and 5. In particular:

- how management companies should make available appropriate information to the unitholders; and
- to whom and how management companies should be able to demonstrate that they have placed orders on behalf of the UCITS in accordance with the company's policy.

One trade association saw a need for guidance on the elements to be taken into account when transactions are handled by a non-EEA service provider.

One trade association requested that the same wording be used as under MiFID. On a similar note, they felt that the requirement in paragraph 3 (to make available appropriate information to the unitholders regarding any material change to their policy) went beyond MiFID and should be removed.

Impact

One respondent believed that CESR's proposals would facilitate cross-border activities and create a more level playing field between different products and services.

In light of the broad support among respondents for CESR's proposals, no significant changes have been made in the final advice. Regarding the provision of information on the execution policy to unitholders, CESR is of the view that the additional text added to paragraph 33 of the explanatory text under Box 7 is also of relevance in this context.

4. Handling of orders related to the execution of portfolio decisions to deal on behalf of the managed UCITS (Box 9 and Box 10)

Respondents broadly agreed with CESR's proposals on the handling of orders. However, two trade associations were of the view that most of the requirements in paragraph 2 were to be implemented by the depositary in practice.

One trade association repeated its point about the proposals not being appropriate in relation to self-managed investment companies.

One trade association reiterated its position that provisions regarding the handling of execution orders should generally not apply to the management company in circumstances where it has delegated to a MiFID firm.

In light of the broad support among respondents for CESR's proposals, no significant changes have been made in the final advice. For the sake of clarity, however, references in Box 10 to 'for own account' have been replaced by 'made when investing their own funds'.

Impact

One respondent believed that the proposal would facilitate cross border activities and create a more level playing field also between different products and services.

One trade association felt that the proposals would not lead to additional costs for management companies in their jurisdiction since they already apply most of these requirements.

5. Inducements (Box 11)

Several respondents agreed with CESR's proposals on inducements.

One trade association urged CESR to make proper allowance for the characteristics of UCITS and their distribution practices when transferring the MiFID inducement standards into the UCITS regime. Any reference to payment of a fee or commission, or provision of non-monetary benefit by a management company should be deleted from Box 11.

Two trade associations agreed with the introduction of inducements provisions felt that the approach needed to take greater account of the specificities of collective portfolio management. In particular, one of the associations questioned how the inducements provisions could be applied in the case of a direct sale by the management company as it would be difficult to quantify which proportion of the management fee should be allocated to the distribution activity.

One trade association shared CESR's view on extending to both collective portfolio management activity and direct sales the MiFID level 2 inducements regulation, subject to the following comments:

- In the first sentence of paragraph 1 box 11, the reference to direct sale should be deleted in order to extend the reference to the category of investors to the collective portfolio management activity.

- Reference to 'the UCITS' in paragraph 1 b) i) should be deleted.

- Paragraph 50 of the explanatory text should be deleted because it goes beyond relevant MiFID level 2 provisions.

One trade association favoured extending the requirement to the 'quality of service provided to investors'. Again, they felt that the wording used should be the same as under MiFID.

One trade association voiced its opposition to the requirement to disclose information on inducements, particularly distribution fees, in the prospectus or periodic reports. They felt that a separate document would be more appropriate otherwise it could lead to misinterpretation by investors, potential distortion of agreements between management companies and distributors and a serious risk of higher distribution costs. Similarly, another respondent sought clarification on the disclosures to be made regarding distribution fees.

CESR has given careful consideration to the feedback from stakeholders on the draft advice on inducements. The final advice makes clear that the scope of the inducements provisions as a whole is designed to cover all functions pertaining to the activity of collective portfolio management activity as defined under Annex II of the UCITS Directive (see paragraph 4 of the Box). CESR has also made a clear distinction between, on the one hand, situations where the management company is providing the service of direct distribution to an investor and, on the other, all other functions that fall within the definition of collective portfolio management.

Impact

One respondent believed that CESR's proposals would facilitate cross-border activities and create a more level playing field between different products and services.

One stakeholder believed the proposals would lead to additional costs and administrative burdens.

Section III: Measures to be taken by a depositary in order to fulfil its duties regarding a UCITS managed by a management company situated in another Member State

General comments

One trade association was of the view that CESR's proposals went beyond the scope of the mandate from the Commission; as such, the respondent strongly urged CESR to reconsider the scope of its proposals and limit its advice to the areas covered by the mandate.

Two associations agreed with CESR's proposals although one felt the list of elements to be included in the agreement was too detailed and would exceed what would be required to achieve harmonisation. Certain critical elements should be set out at Level 2 while specific details should be left to Level 3 guidance.

1. Specific conditions that depositary must meet to fulfil its duties regarding a UCITS managed by a management company situated in another country (Box 1)

Respondents agreed that no additional requirements should be imposed on a depositary when the management company is situated in another Member State.

Due to the positive feedback received from stakeholders on its proposed approach, CESR has confirmed this approach in its final advice.

Impact

Two trade associations foresaw possible increased costs. One believed that placing any additional duties on a depositary in situations where the management company passport is being used could potentially increase costs. In its view, any proposals should be designed to facilitate cross-border agreements rather than add additional complexities or red tape.

2. The standard arrangements between the depositary and management company (Box 2)

a. Are the proposed requirements appropriate?

Respondents made a wide range of comments on the proposals in Box 2. Several commented that the proposed requirements on the content of the agreement were too detailed, while others felt some of the elements would be better handled outside the written agreement altogether (as regards level 2 measures). In contrast, a number of respondents (including three trade associations) agreed with many of the requirements proposed by CESR as they reflected current market practice.

One trade association sought confirmation that depositaries have to be provided with all necessary information by the management company to enable them to carry out their duties, while welcoming the fact that CESR had not prescribed detailed Service Level Agreements.

A large majority members of one trade association disagreed with the proposals in Box 2 on the basis that the agreement should only cover the flow of information required to allow the depositary to perform its duties when the management company is situated in another Member State. Another respondent supported this view and raised particular concerns over the provision in paragraph 9 that required the agreement to contain 'all information regarding the tasks and responsibilities in respect of obligations regarding anti-money laundering and combating the financing of terrorism, where applicable', on the basis that depositaries are not responsible for implementation /day-to-day operation of this policy.

One trade association found the requirements appropriate but felt they should cover three other essential items to allow the depositary to fulfil its duties:

- Procedures for the supervision of investment decisions and eligibility of assets, both by the manager and the depositary;
- Procedures for the control of the fund valuation or procedures for the fund valuation in case the depositary is in charge for computing the relevant NAV;
- Consideration of processes within the depositary to alert the management company and the supervisors, in the case of observed breaches with applicable rules;

One trade association suggested deleting the first sentence of the penultimate paragraph of Box 2, and rephrasing the second sentence in a manner allowing for reciprocal application : '***The agreement*** *shall include a provision regarding the possibilities and procedures for the review of the depositary by the management company* ***and vice versa.'***

One firm was not opposed to the adoption of rules which sought to create a more robust and consistent contractual relationship between the depositary and the management company but believed that certain flexibility should remain.

Regarding the level of detail that would potentially be contained in the written agreement, CESR has introduced some flexibility has in the final advice – in paragraphs 4 and 5 in particular – to make clear that much of the detail can be contained in the service level agreement or similar document.

Some respondents proposed to restrict the content of the agreement to cover only the flow of information required to allow the depositary to perform its duties when the management company is situated in another Member State; CESR feels it is important to set a minimum level of prescription in the information contained in the written agreement, particularly given that CESR does not propose to impose any other additional requirements on depositaries in situations where the management company passport is used.

Finally, CESR believes that there is sufficient flexibility in the text as regards the obligation related to anti-money laundering and combating the financing of terrorism, due to inclusion of the term 'where applicable'.

b. Are the information flows exchanged in relation to the outsourcing of activities by the management company or the depositary relevant?

Respondents made a number of specific comments in response to this question.

One trade association agreed with the proposals provided that their application is left to the discretion of the contractual parties.

Two trade associations agreed that the information flows regarding the operations of the management company that relate to the tasks of the depositary are important, while two other respondents did not believe them to be relevant.

Several respondents believed that the exchange of information on outsourcing should take place only if the depositary is directly affected by the activity which forms part of the outsourcing.

One trade association was of the view that the information flows exchanged in relation to the outsourcing of activities by the management company should be addressed on a case-by-case basis and that a general obligation of access might not be justified.

One firm found CESR's proposal relevant but believed that great care should be taken with the term 'outsourcing' as this language could imply that the outsourcing party has the option of performing this function, while in most cases it is a market necessity (e.g. no direct access possible for custodian services in emerging markets).

CESR believes it is important to ensure adequate information flows between the depositary and the management company, both in cross-border situations (use of the management company passport) and when the entities are located in the same Member State. In its advice, CESR has deliberately foreseen that the information on outsourcing be exchanged by both parties. No changes have been made compared to the draft advice published for consultation in this area.

c. Is it appropriate to indicate in the written agreement that each party may request from the other information on the criteria used to select delegates? In particular, is it appropriate that the parties may agree that the depositary should provide information on such criteria to the management company?

Most respondents (including a number of trade associations) did not consider it appropriate that requirements for the choice of the depositary's sub-custodian network should be 'agreed between the management company and the depositary'; they felt that the management company should not be able to intervene in the depositary's selection of sub-custodians and should not be able to impose any constraints on this selection. They suggested the following amendments to Box 2:

- Paragraph 1 should clarify that the agreement must include information about the depositary's sub-custodian network;
- Paragraph 2: conditions concerning the termination of contract should include the notice period and the specific pieces of information that would be considered 'relevant' for sending to the successor;
- Paragraph 5: The word 'custody' should be replaced by 'safe-keeping';
- Paragraph 9: Some flexibility must be maintained to allow parties to agree precisely what pieces of information would fall under this point;

Several respondents felt that were such an obligation to be introduced, there should be a reciprocal duty on the management company with respect to its own outsourcing arrangements.

As noted above, CESR considers it important that the parties have the possibility to request information on outsourcing arrangements, including on the criteria used to select delegates. However, CESR has taken into account some of the comments made by stakeholders by removing the following text in paragraph 1 of Box 2: 'an indication of whether the depositary is free to select a sub-custodian(s) or if it has to inform the management company about the sub-custodian network it may use'. The term 'custody' has also been replaced by 'safekeeping' in paragraph 5.

d. Is the split between suggestions for Level 2 measures and envisaged level 3 guidelines appropriate?

Most respondents saw merit in CESR's proposed split of requirements between levels 2 and 3. However, several believed that there should be flexibility as to the level of detail in the agreement and supported CESR's proposal not to cover the drafting of standard terms but rather include a set of general requirements in Level 2 measures. One respondent also highlighted the importance of there being appropriate public consultation on any level 3 measures.

Two trade associations saw no immediate need to elaborate on the level 2 measures via level 3 guidelines on the content of the depositary agreement.

One trade association favoured restricting the level 2 measures to a general clause requiring the management company to provide to the depositary any information the latter requires in order to fulfil its duties, and an obligation to ensure that no laws or regulations in the management company's home state could hinder effective transmission of information to the depositary. Beyond these two elements, the respondent felt that level 3 guidelines would be the most effective approach.

In light of the general support for CESR's proposals, this approach has been confirmed in the final advice.

e. Do you see a need for level 2 measures in this area or are the level 1 provision sufficiently clear and precise?

Three respondents believed there was no need for level 2 measures.

Five respondents took the view that the level 1 provisions on the agreement between the management company and the depositary were not sufficient and should be complemented by level 2 measures.

CESR has confirmed its view, shared by a majority of respondents, that the level 1 provisions should be complemented by level 2 measures.

f. Do you consider that the proposed standard arrangements and particulars of the agreements are detailed enough?

The majority of respondents considered CESR's proposals to be sufficiently detailed.

In light of the support from the majority of respondents, CESR has confirmed its proposed approach in the final advice.

g. What are the benefits of such standardisation in terms of harmonisation, clarity, legal certainty etc?

Several respondents did not envisage any significant benefits from CESR's proposed approach. However, most respondents identified the creation of a level playing field across the EU as the main benefit of CESR's proposals. One trade association also felt the increased standardisation would ultimately benefit investors by ensuring both parties can carry out their duties in an efficient manner regardless of the jurisdiction.

h. What are the costs for depositaries and management companies associated with the proposed provisions?

Most respondents believed that the costs would vary across countries and firms. One respondent felt that the proposed provisions would lead to additional costs for depositaries and management companies but did not provide any specific estimates.

3. Level 2 measures on the law applicable to the agreement between the management company and the depositary (Box 3)

Several respondents disagreed, preferring an approach whereby parties could choose freely the applicable law. However, a large majority of respondents (a mixture of firms and trade associations) agreed with the proposal on the basis that it would ensure an appropriate level of investor protection as well as facilitating the depositary's supervisory function regarding the management company's compliance with the fund rules.

Taking into account the support of most respondents for CESR's proposed approach, this has been confirmed in the final advice.

Impact

Two respondents foresaw increased legal fees for management companies as a result of CESR's proposal. One respondent agreed while predicting that there would be no additional costs for depositaries.

4. Need for different provisions in relation to investment companies (Box 4)

Respondents agreed with the proposal on the basis that it would foster a level playing field between different types of UCITS.

CESR has confirmed its proposals in the final advice.

5. Possibility to advise the European Commission to extend these requirements to domestic structures (Box 5)

A large majority of the respondents agreed with the proposal.

Several respondents did not see a need to extend the provisions to purely domestic situations and felt there was no legal basis for such an extension.

In light of the support of the majority of respondents, and with a view to ensuring a level playing field between depositaries, CESR has made no changes to its proposal to extend the provisions of the advice to purely domestic situations.

Impact

One respondent expected the proposals to lead to significantly increased costs for the UCITS sector. However, most respondents who commented on this point stated that a level playing field would ultimately benefit investors by ensuring all parties are aware of their obligations. One trade association noted that the new measures should not require existing contracts to be renegotiated unnecessarily.

Section IV: Implementing measures on risk management

1. Impacts of CESR's proposals on risk management and risk measurement.

Several trade associations believed that incremental costs associated with the implementation of the revised global exposure calculation were to be expected. However, one association stated that these costs are not likely to be material in comparison with the original cost of implementing VaR and the associated processes. None of the respondents gave any estimate of costs.

One association stated that the proposals were in line with the current approach of their domestic regulation and therefore should not entail additional costs.

Regarding benefits, two associations believed that the proposals would give comfort to competent authorities, managers, depositaries and investors.

2. Identification of risks relevant to the UCITS (Box 1)

Most respondents agreed with CESR's proposal on the scope and objectives of risk management.

One association felt that it would be important that adequate level 3 guidance supported the level 2 requirements.

One respondent asked for clear guidance on the form of the risk management policy and expressed the view that a separate document should be compulsory.

One association generally agreed with the proposal but stressed that sufficient flexibility should be given to allow the risk management policy to be adapted to the actual risks incurred.

In light of the general support among respondents for CESR's draft advice, CESR has confirmed this approach in the final advice submitted to the Commission.

Impact

One respondent did not see any additional costs arising from this approach as it was already widely provided for by many existing regulations.

Three trade associations were expecting an increase in costs but did not provide any estimates. Standardisation of the risk management approaches used by firms was identified as a benefit.

3. Risk management function (Box 2)

A majority of respondents agreed with CESR's proposals on the organisational requirements. Of these, one asked for a clarification that a management company may not have a risk management function if it is proportionate to the nature, scale and complexity of the management company's business and of the UCITS it manages.

One association took the view that valuation and risk management functions were separate and independent. Their view that the functions should co-operate but the risk management function should not take on valuation duties.

One association believed there might be some technical difficulties arising from the risk management function getting access to *all* relevant information. In the respondent's view, this

wording was too wide and should be more focused in order to avoid the risk function being exposed to undue legal risks.

In light of the broad support from respondents for CESR's proposals, this approach has been confirmed in the final advice submitted to the Commission. Some additional text has been added, however, to make a link between the duties of the risk management function and the provisions on risk measurement set out in Boxes 9 to 12 of the advice. CESR confirms that the requirement to have a separate risk management function is subject to a proportionality test i.e. the nature, scale and complexity of the management company's business and of the UCITS it managed must be taken into account.

Impact

One association identified greater harmonisation as one of the benefits of CESR's proposals. Another respondent did not envisage any additional costs arising from this approach as it was already widely provided for by many regulations.

4. Risk management activities performed by third parties (Box 3)

Most respondents agreed with CESR's proposals on the organizational requirements and safeguards. According to one, it would establish a fully coherent legal framework for a management company which provides both investment services and collective portfolio management.

One respondent stressed that the processes and responsibilities in the event of outsourcing to a third party needed to be clearly defined in the following way: (i) calculation of the risk measure through an appropriate engine; (ii) definition of the appropriate risk profile; (iii) production of exception reports; and (iv) investigation, monitoring and escalation to authorities.

The same respondent felt that the requirement for a management company to *'take all reasonable steps to ensure continuity to the risk management process in case of interruptions to the risk management activities performed by 3rd parties'* may be very difficult for small entities.

Taking into account the broad agreement among respondents with CESR's draft advice, CESR has confirmed its proposals in the final advice. CESR believes that the requirement to 'take all reasonable steps' regarding the continuity of the risk management process already reflects the principle of proportionality, and is therefore appropriately calibrated depending on the size of the entity.

Impact

One association believed the proposals would not lead to additional costs since delegation to third parties is generally done for economic reasons. Two others envisaged that no additional costs would be borne by management companies if they carried out periodic reviews of the third party.

One association anticipated additional costs but was not able to quantify them.

One respondent did not envisage any additional costs arising from this approach as it was already widely provided for by many regulations.

5. Measurement and management of risks (Box 4)

The majority of respondents agreed either fully or in general with CESR's proposals on the risk management systems and procedures.

One association felt that the requirements in paragraph 22 of the Explanatory Text regarding IT systems were too detailed.

Two associations generally agreed with the proposals but felt that the proposed ongoing counterparty risk requirement should be defined as it may lead to a real-time or intra-day requirement, which would create issues with UCITS undertaking OTC transactions (including simple forward FX trades).

One association believed that the principle of proportionality should be applied to the requirement that the risk limit system 'should cover all risks to which a limit can be applied and should take into account their interactions with one another'. Such a requirement should notably be implemented with due regard to the complexity of the UCITS managed.

One trade association felt that the wording 'at any time' and 'might be exposed' in Box 4, paragraph 1 were too wide. Their view was that the principle of proportionality should apply to this temporal element as in some cases it was not possible to measure and manage fully the risks on a pre-trade basis or even on an intra-day basis.

One trade association disagreed with the use of the term '*ensure*' in paragraph 3 of Box 4 concerning the liquidity risk, as they felt that this created an obligation of result which would make the management company responsible for every sudden lack of liquidity.

With regard to the due diligence requirements for investment in hybrid instruments embedding derivatives, one respondent stressed that the nature, scope and frequency of checks performed depended on the characteristics of the embedded derivatives and their impact on the UCITS. Where the UCITS considers that the impact is not significant, there should be sufficient flexibility to allow the controls to be tailored accordingly.

Given the general support among respondents for CESR's proposals, no significant changes have been made to the advice published for consultation. As in Box 2, however, some text has been added to the Box and the Explanatory Text to make an appropriate link with the advice on risk measurement in Boxes 9 to 12.

Impact

Several trade associations assumed that the proposals would lead to additional costs but were not able to quantify the amounts.

One respondent did not envisage any additional costs arising from this approach as it was already widely provided for by many regulations.

6. Responsibility of the board of directors and internal reporting (Box 5)

All respondents agreed with CESR's proposals on the requirements concerning the responsibility and governance of the risk management process.

However, one trade association believed CESR should distinguish between, on the one hand, situations where functions are delegated to other parties and, on the other, where the management company is performing a simple oversight role.

In light of the strong support from respondents for CESR's proposals, no changes have been made in the final advice other than a clarification of the reporting duties as set out in paragraph 34 of the Explanatory Text.

Impact

Two trade associations explained that they were not aware that the proposals would result in any additional direct costs, but felt they may require additional reporting which could incur extra costs.

One trade association envisaged additional costs but was unable to quantify them.

One respondent did not envisage any additional costs arising from this approach as it was already widely provided for by many regulations.

7. Procedures for the valuation of OTC derivatives (Box 6)

The majority of respondents fully agreed with CESR's proposals on the link between the risk management policy and the valuation of OTC derivatives.

Two trade associations suggested that the sentence '*the risk management function should be appointed with specific duties and responsibilities for this purpose*' in paragraph 3 should be deleted, on the basis that risk management functions are different from those of the function in charge of the valuation of the portfolio.

One trade association agreed, in principle, with the necessary link between the risk management policy and OTC valuation at the level of the risk management function by including both activities in the risk management policy. In their view, however, the management company should have the possibility, taking into account its business model, to delegate both activities to different units or service providers as long as the constraints of Box 6, paragraph 1 are complied with.

One respondent supported the proposed procedure for the valuation of OTC derivatives and believed that risk management methods were necessary in line with the proportionality principle.

In light of the support from respondents for CESR's proposals, the approach set out for consultation has been confirmed in the final advice. CESR has, however, clarified what it sees as the interaction between the risk management and valuation functions as set out in paragraph 42 of the Explanatory Text.

a. Extension of the application of the requirements set out in Box 3 to the valuation arrangements and procedures concerning OTC derivatives.

Respondents agreed with CESR's proposal to extend the application of the requirement set out in Box 3 to the valuation arrangements and procedures concerning OTC derivatives which involve the performance of certain activities by third parties.

As respondents supported the proposal to apply the requirements of Box 3 to the valuation arrangements and procedures concerning OTC derivatives, CESR has confirmed this approach in its final advice.

b. Extension of the requirements set out in Box 6 to the valuation of other financial instruments which expose the UCITS to valuation risks equivalent to those of OTC derivatives.

Two trade associations agreed with CESR's proposal although one noted that attention should be paid to the costs incurred in obtaining information on illiquid financial instruments.

Two trade associations did not believe that the proposals in Box 6 would be relevant to other types of financial instrument that have valuations risks equivalent to those of OTC derivatives.

One trade association did not support the proposed extension in paragraph 5 as they saw no legal basis in level 1. The same respondent also believed that CESR's proposal should be in line the Eligible Assets Directive (EAD), and suggested the wording of paragraph 1 (i) be modified as follows to reflect the EAD: *'the basis for the valuation is either a reliable up-to-date market value of the instrument, or, if such a value is not available, a pricing model using an adequate recognised methodology'*. The words *'or meaningful'* would have to be deleted in CESR's text and 'recognised' be added.

CESR considers it important that the principles set out in Box 6 be taken into account in the valuation of instruments that present valuation risks equivalent to those of OTC derivatives. It is a matter for the Commission to consider whether there is an appropriate legislative basis at level 1 for such a provision.

CESR has taken into account the comments above regarding paragraph 1(i) and made changes to ensure consistency with the Eligible Assets Directive.

c. Extension of the requirements set out in Box 6 to the valuation of the embedded derivative element of the financial instruments. Should these requirements apply to the valuation of all such instruments?

Most respondents disagreed with this proposal.

Those respondents who disagreed made a number of comments to explain their opposition. Several believed that separate valuations of derivatives were not necessary because embedded derivatives are included in the valuation of the structured product's price, while another stated that the requirement of the Eligible Assets Directive related to the exposure calculation for UCITS, not to the valuation of embedded derivatives products.

Finally, one respondent considered that the requirements referred to in Box 6 should apply to the financial instrument as a whole, whether it includes OTC derivatives or not. In their view, applying the requirements of Box 6 to the valuation of the embedded OTC derivatives separately would seem rather arbitrary, and might give a misleading overall picture of such a financial asset.

CESR recognises the additional valuation risks that can be posed by embedded derivative instruments. For this reason, the Explanatory Text in paragraph 42 makes specific reference to such instruments in the context of the interaction between the risk management and valuation functions.

Impact

Most respondents believed the proposals would lead to additional costs but did not give an estimate of these costs.

One respondent suggested it should be the responsibility of each management company to set up its OTC valuation process and integrate it in the risk management policy in an efficient way to avoid unnecessary costs.

One respondent did not envisage any additional costs arising from this approach as it was already widely provided for by many regulations.

8. Supervision (Box 7)

Respondents broadly agreed with CESR's proposal but made some specific comments.

One respondent suggested replacing the words '*competent authorities*' with '*home competent authorities*'. The same respondent believed that the authorities in charge of authorising a new UCITS should 'rely' on (not 'may take into account') the appraisal carried out by the home competent authorities of the management company's risk management process.

One trade association sought changes in the text in order to clarify that the provisions did not refer only to situations where the UCITS and the management company are situated in the same Member State.

One trade association noted that the regulators would need to have enough resources and sufficiently skilled people to carry out their supervisory functions. With regard to the ongoing review of the adequacy and effectiveness of the risk management process, the respondent believed that management companies should be given the role of notifying any material changes to the competent authorities, if necessary, rather than the authority asking for updates on a periodical basis.

One respondent felt that the provision on reviewing the risk management process at the moment of authorisation of new funds (paragraph 45 of Explanatory text) could be an obstacle to the authorisation process.

In light of the broad support among respondents for CESR's proposals, this approach has been confirmed in the final advice. CESR notes that the level 1 Directive sets out a clear allocation of responsibilities between the competent authority of the UCITS and that of the management company in cases the two entities are not in the same jurisdiction.

In order to ensure there is an appropriate link between the requirements on risk management and those on risk measurement in Boxes 9 to 12, some text has been added to paragraph 46 of the Explanatory Text to make clear that competent authorities should also consider the appropriateness of the methodologies and procedures adopted by the management company to comply with the statutory limits on global exposure and counterparty risk.

Impact

Two respondents believed that the proposals related to the authorization process and the supervisory approach of competent authorities would lead to additional costs but could not provide an estimate.

a. Application to investment companies of the risk management requirements set out in this document

Respondents agreed with CESR's proposals on the application to investment companies of the risk management requirements.

CESR has confirmed the application of the risk management requirements to investment companies.

Section V: Implementing measures on supervisory co-operation.

Two respondents agreed with all of CESR's proposals for this section. Another was of the opinion that efficient supervisory co-operation was crucial for the functioning and the success of UCITS IV and that any supervisory arbitrage had to be avoided. No specific comments were made by the other respondents.

As the only respondents that commented on this section of the draft advice were in favour of the proposals, CESR made no changes in the final advice submitted to the Commission.

Annex 1 – List of respondents

	Name of respondent
1.	Association Française de Gestion
2.	Association of the Luxembourg Fund Industry
3.	Assogestioni
4.	AXA Investment Managers
5.	Barclays Global Investors
6.	BNP Paribas
7.	Capitects
8.	Depositaries and Trustees Association
9.	European Association of Co-operative Banks
10.	European Banking Federation
11.	European Fund and Asset Management Association
12.	European Savings Banks Group
13.	Eversheds
14.	Irish Funds Industry Association
15.	Investment Management Association
16.	Inverco
17.	Italian Banking Association
18.	Raiffeisen Capital Management
19.	Skandinasviska Enskilda Banken
20.	Swedish Investment Fund Association
21.	Bundesverband Investment und Asset Management
22.	State Street
23.	Austrian Federal Economic Chamber
24.	Zentraler Kreditausschuss
25.	Fédération Bancaire Française- Association Française des Professionnels des Titres