

Consultation on the UCITS Depositary Function

Submission from The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the European Commission's consultation on UCITS depositaries.

The AIC is the trade body representing some 350 closed-ended investment companies, the vast majority of which are traded on EU regulated markets. Our Members are closed-ended funds that invest in a portfolio of assets, including shares listed on EU regulated markets, to provide shareholders with an investment return.

Investment companies are not regulated by the UCITS Directive. However, the proposed changes to the UCITS depositary rules are very relevant to our members as they reflect the proposals to require AIFs to have a depositary, as set out in the draft Alternative Investment Fund Managers (AIFM) Directive.

The AIC supports the position of the Presidency (published in an Issues Note on the AIFM Directive on 2 September 2009) to postpone any decisions on the depositary rules in the AIFM Directive until the completion of this UCITS review. There are many similarities in the depositary arrangements for both UCITS and non-UCITS funds and a consistent approach is sensible. The findings of this review should be used to inform the requirements for depositary arrangements in the AIFM Directive.

General comments

The regulatory framework applied to the depositary function, whether in relation to the UCITS Directive or the AIFM Directive, should recognise the diversity of the providers which can perform this function. For example, the provision of depositary services should not be limited to credit institutions, which is currently a proposal in the AIFM Directive.

Furthermore, there is no regulatory reason why the envisaged services provided by a depositary (identified in the draft AIFM Directive as being receipt of payments, safe-keeping of assets, and verification of ownership) should be performed by a single entity. There are indeed benefits from separating activities to different specialist service providers, e.g. spreading counter-party risk.

Any regulatory changes to the depositary framework should be proportionate. They should recognise that different approaches may be appropriate in different circumstances. The cost of implementing the rules should also be considered. If obligations are introduced which are too stringent and restrict commercial flexibility, compliance costs (which reduce investment returns to consumers) are likely to outweigh the benefits of the incremental increase in protection for investors that the requirements are purported to deliver.

Receipt of payments made by investors

The proposed approach to depositaries does not recognise that responsibility for processing payments for investors may not currently be carried out by a depositary. For example, investment companies, and other share issuers, typically employ a registrar to perform this service. On the issue of new shares, the registrar receives and processes the application forms and accompanying funds. There is no question that these arrangements are inappropriate or ineffective, and billions of Euros have been raised on EU regulated markets using this mechanism. The custodian, or any other appropriate party, should be allowed to continue to offer this service.

Safe-keeping of financial instruments

Depositary duties should take account of the nature of the assets held. As noted above, investment companies hold shares in other listed companies. They typically employ a third party 'custodian' to safeguard these share certificates. However, custodial arrangements may not be relevant for all types of investments. For example, investment companies also invest in more illiquid assets, such as private equity and property. These assets are not transferable in the same way that listed share certificates are. It would be disproportionate to require ownership documents for these types of assets to be placed with a depositary. The costs of complying with such stringent depositary obligations would exceed any additional protection afforded to investors.

Verification of ownership

The proposals suggest that depositaries should be given specific responsibility for verifying the ownership rights of the assets held in the fund. It does not recognise that, for investment companies, this role is also performed by the fund's external auditors, who must comply with strict auditing standards. Unless real value is added by requiring a separate depositary to undertake this activity, this obligation should not have to be delivered by a depositary if alternative arrangements (i.e. independent audits) already provide necessary assurances.

The consultation paper identifies the Madoff fraud as one of the key drivers for reviewing depositary services. The nature and extent of this fraud has raised concerns from many quarters. However, this incident should not be a critical factor for deciding policy changes to the depositary framework. The main reason for this fraud was the failure to acquire assets, not the way in which those assets were safeguarded. Any semblance of a due diligence process would have identified these unusual arrangements. Regulation should not be designed around what were, in fact, already illegal activities.

Credit institutions

The draft AIFM Directive says that depositary services can only be offered by EU credit institutions. Currently, the depositary arrangements of investment

companies and other types of funds are carried out by a range of different institutions. The AIC has a number of concerns about narrowing the range of providers. The AIFM Directive ignores the fact that established providers operate in other sectors of the market and provide a service which is robust and cost-effective. Only allowing EU credit institutions to offer depositary functions will reduce the number of entities in this field and lead to higher costs, which are likely to be passed onto the depositary's clients. Having a lower number of depositaries will also increase counter-party risk, as each entity will assume more responsibility. Even though the draft AIFM Directive allows depositaries to sub-delegate, the third party must be another EU credit institution. Therefore, this does little to reduce the systemic impact of increased counter-party risk. This creates market risks and threatens the integrity of EU credit institutions themselves.

Furthermore, there are situations in which EU credit institutions will not be able to act as a depositary. For example, certain non-EU countries, such as Russia, require securities issued in their own country to be held by a local depositary. Imposing these arrangements would unacceptably limit the geographic diversity of AIFs and UCITS funds.

Liability

Any liability regime imposed on depositary services should be proportionate and based on a 'reasonableness' test. Failure to take this approach would substantially increase the costs of performing this function. A depositary may be forced to take out more insurance cover or to hold more capital, the costs of which are likely to be passed onto its clients. Anecdotal evidence suggests that some funds could potentially encounter increased costs in the region of 3 basis points. This would be damaging to the sector and would have a disproportionate effect on smaller funds, such as venture capital trusts, which operate within very tight margins.

Conclusion

In the context of the AIFM Directive, it is difficult to identify the benefits of imposing the proposed depositary requirements on investment companies. The AIC does not support the draft regulations in their current form. The regulatory framework applicable to depositaries needs to be commercially flexible, allowing different models to be applied to the proposed depositary functions. Whether on behalf of institutional or private investors, the key objective is to ensure that appropriate arrangements are in place for the safe-keeping of assets. The specific type of entity which performs this function is of lesser importance. Regulation should also ensure that the liability regime is reasonable.

This formal consultation provides an excellent opportunity to create an effective depositary mechanism for UCITS funds, and those to be covered by the AIFM Directive. This exercise for UCITS funds should lead to the development of an improved framework which is based on informed and

evidence-based views. Any decisions on the depositary rules within the AIFM Directive should not be taken until this debate is concluded.

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