

What Role for Depositaries under AIFM/UCITS Directives?

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Brief history and features of the EU asset management legislation

The UCITS Directive

- Adopted in 1985 to regulate a 'product': units of undertakings for collective investment in transferable securities (UCITS)
- Represents cornerstone of EU regulation for retail investment fund products
- Subject to many reviews, latest of which 'UCITS IV' in 2009
- In the process of being amended as 'UCITS V' and part of post-crisis EU financial reform package

The AIFM Directive

- Adopted in 2011 to regulate alternative investment fund managers (AIFMs)
- Closes regulatory loophole and extends EU passport to compliant AIFMs (as of 2015 for non-EU AIFMs)
- To be implemented by EU Member States into national law by July 2013

The UCITS Directive: rules for depositaries only partial

The UCITS Directive sees depositary perform 2 key functions:

- i. Asset safe-keeping
- ii. Oversight over management company

...with some inherent weaknesses:

- ✓ No implementing (detailed) measures
- ✓ Different eligibility requirements dependant on national laws
- ✓ Safe-keeping remains ill-defined and not tailored to nature of asset classes
- ✓ No explicit requirements for asset segregation
- ✓ No rules on cash-flow monitoring
- ✓ Divergent interpretations of liability regime across EU Member States

The AIFM Directive: more stringent requirements

The AIFM Directive on the other hand:

- Complements UCITS regulation by capturing alternative investment managers (AIFMs) and introduces new benchmarks for the exercise of depositary functions and scope of its liability...
- ... while introducing improved features:
 - ✓ Clear rules on depositary eligibility: either a credit institution or an investment firm defined under EU law
 - ✓ Detailed definition of safe-keeping duties: split between custody and record-keeping, depending on asset types
 - ✓ Strict demands in terms of clients' account segregation
 - ✓ Introduction of rules to monitor fund cash-flows (including from and to third-party providers, e.g. prime brokers)
 - ✓ Clear rules on depositary liability, confining possibilities for the discharge of liability and accounting for delegation of safe-keeping duties to third parties

Safe-keeping: depending on asset type, depositaries shall be entrusted with:

1. Custody duties for instruments meeting 3 criteria: i) are transferable securities, MMFs or units of collective investment undertakings; ii) if provided as collateral, control or possession over it remains with depositary; iii) instruments are registered or held in an account in the name of a depositary
 - ✓ Instruments to be registered in segregated accounts on the depositary's books and the depositary to conduct regular reconciliations between internal accounts and records of any third parties holding the assets
 - ✓ Monitor risks along the custody chain, and apply a 'look-through' approach to those structures controlled by the fund/AIFM

2. Record-keeping for all instruments not eligible for custody, typically:
 - ✓ physical assets that do not qualify as financial instruments or cannot be physically delivered to the depositary
 - ✓ financial contracts (derivatives)
 - ✓ instruments issued in nominative form or registered with the issuer (or through its registrar) that are not held in an account in the name of the depositary
 - ✓ cash deposits
 - ✓ investment in private companies (or partnerships)
 - ✓ For these, depositary to be guaranteed timely access to info (including from prime brokers) to verify ownership rights and keep inventory of assets up-to-date

The AIFM Directive: more stringent requirements

Oversight

- Depositary is to perform ex-post controls and verifications of processes and procedures that are under the responsibility of the AIFM, the AIF, or an appointed third-party
- Depositary to be provided with all information (including from 3rd parties) and able to perform on-site visits (internal or external to the AIFM)
- Where needed, depositary may review certifications from external auditors or experts to ascertain that the AIFM is complying with its obligations
- There are 5 key oversight functions:
 - i. Reconciliation of subscription/redemption orders with the subscription proceeds/redemptions paid, and of the number of units or shares issued/cancelled with the subscription proceeds received/redemptions paid by the AIF
 - ii. Valuation of shares/units
 - iii. Verification of compliance of AIF/AIFM with national law or its instruments of incorporation, as well as with investment restrictions and leverage limits defined in offering documents
 - iv. Ensure timely settlement of transactions
 - v. Correct income calculation with respect to AIF instruments and applicable law, liaising eventually with auditors and verifying accuracy of dividend payments

The AIFM Directive: more stringent requirements

Cash-flow monitoring

- Depositary is to ensure the AIF cash is booked in one or more cash accounts opened at an entity that is either a:
 - ✓ central bank
 - ✓ credit institution
 - ✓ bank authorized in a 3rd country
 - ✓ qualifying MMF
- ... and it should ensure:
 - ✓ proper procedures to reconcile all cash flow movements and identify potential ones inconsistent with the fund's operations
 - ✓ reporting anomalies to manager without undue delay
 - ✓ a reconciliation process to be reviewed at least once a year to check consistency of depositary's records with those of the AIFM

The AIFM Directive: more stringent requirements

Liability

- Is triggered in the event of:
 - ✓ Failure or professional negligence
 - ✓ Loss of financial instrument held in custody by depositary, or by its sub-custodian(s)
- In case of loss, depositary must return a financial instrument of the identical type or the corresponding amount, **without undue delay**
- Depositary may discharge itself on 2 conditions:
 1. If it can prove loss was result of an **external event** beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary, or
 2. If there is an '**objective reason**' expressly contemplating such discharge in an agreement signed *ex-ante* with a 3rd party sub-custodian
- Compared to the UCITS, depositary liability under AIFM Directive has been **significantly reinforced** and thanks to implementing measures it should be harmonized amongst EU Member States...

‘UCITS V’ review: full alignment with AIFM?

To guarantee a ‘level playing-field’ for the EU asset management sector, EC has launched its 5th review of UCITS Directive (‘UCITS V’)

- Initiative based on 3 pillars:
 1. Depositary rules (functions and liability regime)
 2. Remuneration policies (alignment with AIFM principles)
 3. Common regulator sanctioning regime (only administrative) for AIFM and UCITS
- On depositary rules, ‘UCITS V’ shall upgrade the current retail regime to match the higher AIFM standards (particularly in terms of investor protection)
- However, departure from AIFM regime is expected in terms of an **even stricter liability**, barring possibility for depositary to contract liability discharge via written agreements
- Initiative is expected to be adopted by the EC in **March or April 2012**

Thank you for your attention ... questions?

Obrigado pela vossa atenção ... perguntas ?