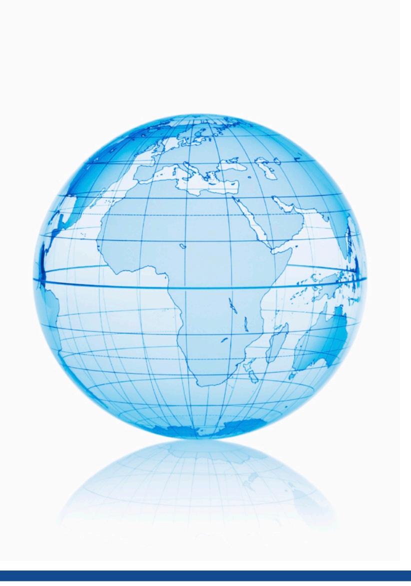
Alternative Investment Management Association

AIMA POSITION PAPER

UCITS V



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Introduction

The Alternative Investment Management Association ('AIMA') welcomes the close attention given by the European Commission (the 'Commission') to amending Directive 2009/65/EC (the 'UCITS Directive') on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities ('UCITS') as regards depositary functions, remuneration policies and sanctions.

AIMA welcomes much that is contained in the Commission's proposal to amend the UCITS Directive (the 'Proposal'). However, as set out below, AIMA considers that the Proposal should seek to align the UCITS depositaries regime and remuneration requirements with that of the alternative investment fund managers directive (the 'AIFMD') as far as possible and should also contain a possibility for the depositary to discharge its liability.

Our comments below seek to explain why we have certain reservations with the current text of the Proposal. We believe that, with these concerns appropriately addressed, the revised UCITS regime will better achieve the Directive's intention of integration and harmonisation of Europe's financial markets.

Since the Proposal will harmonise the UCITS legislative framework relating to depositaries, AIMA considers that now would be the best time to make provision in the UCITS Directive for a depositary passport. Our comments below seek to explain why we consider that not providing for a depositary passport impedes the openness of the internal market.

Main areas of concern to AIMA

1. Depositary liability

AIMA's key points:

- AIMA considers that sub-custodians should not be deemed internal to the depositary for the purposes of determining liability for lost assets.
- If this is not achievable, the liability regime for UCITS depositaries should at least be aligned with the provisions in the AIFMD by allowing liability discharge in certain circumstances.

Under the Proposal a depositary will be liable to return a financial instrument of identical type or the corresponding amount to the UCITS or the management company acting on behalf of the UCITS without undue delay if a financial instrument held in custody by the depositary itself or a sub-custodian is lost. The only way in which a depositary will be able to discharge this liability is if "it can prove that the loss was a result of an external event beyond reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary." If interpreted literally, this provision does not appear to impose strict liability on the depositary. It should be clarified that acts occurring at the sub-custodian are external to the depositary.

If the phrase 'external event beyond reasonable control of the depositary' is interpreted in the same way as it is likely to be in the AIFMD level 2 regulation, UCITS depositaries will only be able to discharge their liability in extremely limited circumstances. This would be very disruptive to the industry. The AIFMD level 2 regulation definition could result in the depositary being responsible for events which occur at the level of the sub-custodian over which the depositary may not have any control. As an example, if a loss were due to an accounting error or an operational failure at the sub-custodian, that would be considered as an 'internal' event and would trigger the depositary's restitution obligation.

The AIFMD level 2 results, in effect, in strict liability for depositaries as the possibility to discharge liability is very restrictive and will only be possible for Acts of God or acts of state such as nationalisation. This will have the effect of discouraging investments in other markets as depositaries will be discouraged from using sub-custodians and will ultimately make the depositary liable for investment risk.

Article 24(2) of the Proposal simply says that a depositary's liability shall not be affected by any delegation referred to in Article 22(7). This means that the depositary does not escape potential liability for loss simply by delegating. Any liability for loss by the depositary, or by a third party to whom it has delegated, should therefore be assessed in accordance with Article 24(1).

By making depositaries liable for acts or omissions of a sub-custodian, acts or omissions of a sub-custodian can never be "external" events and therefore must be internal. AIMA disagrees with this interpretation, the effect of which would make the depositary strictly liable for all acts and omissions of any sub-custodian, regardless of the degree of control which the depositary can meaningfully exert.

It is a practical reality that many depositaries will need to delegate to many unaffiliated sub-custodians over whom depositaries have no control or influence at all. A natural interpretation of the word "external" would, in AIMA's view, be one that recognises that the acts and omissions of such sub-custodians are necessarily "external". That would mean that the depositary's liability for the acts or omissions of unaffiliated sub-custodians will still remain.

By imposing strict liability on the depositary for its own failures and for those of any sub-custodians which it appoints, custodians are likely to reconsider whether they are prepared to act in respect of some funds, such as emerging markets, because of the increased risk of being held liable for losses. Where the custodian decides to act, fees would inevitably be increased in order to reflect the greater risk which is being assumed. Equally inevitably, this additional cost would be passed to the end investor, resulting in higher costs and lower returns on the investment.

If a regime of strict liability is to be imposed on UCITS depositaries, AIMA considers that the UCITS regime should be aligned as much as possible with that of the AIFMD and that the regime for UCITS depositaries should not be yet more burdensome. As such we suggest that continuing work on the UCITS depositary function closely follows the level 2 measures being debated in relation to the AIFMD and rules for UCITS should not be developed prematurely. Alignment of the regimes without additional burdens or differing compliance requirements should maximise the potential choice of depositaries which funds and their managers can use, which has two key benefits. The first is keeping industry costs and operational risks to a minimum, for the benefit of all investors, and the second is maximising competition in the industry, which may also help drive down cost but should certainly reduce the possibility of custody risk becoming too concentrated in a small number of depositary providers. For the same reasons, the obligations of depositaries under both regimes should be harmonised with the requirements of the markets in financial instruments directive (MiFID) and/or the Securities Law Directive to the maximum extent possible.

Nevertheless there remain some important differences between the functions and purposes of a UCITS depositary (as compared with the depositary of an AIF), which should be reflected. In particular, unlike the UCITS directive, the AIFMD does not regulate the asset classes in which an AIF can invest (and these will accordingly be far broader than those in which UCITS funds invest). This difference has been expressly acknowledged in the AIFMD and we suggest similar recitals and overriding principles be incorporated into the UCITS directive to ensure proportionate implementation. Whilst alignment of the regimes should bring practical benefits to the industry, implementation of rules for UCITS depositaries should be conducted with the question "what is the most appropriate and proportionate depositary regime for UCITS?" firmly in mind.

AIMA is concerned that the depositary liability regime for UCITS set out in the Proposal is broader than that of the AIFMD. Article 21(13) of the AIFMD permits a discharge of liability where financial instruments held in custody by a third party are lost if the depositary can prove that certain conditions are met, such as that there is a written contract between the depositary and the AIF or the AIFM acting on behalf of the AIF, expressly allowing a discharge of the depositary's liability and establishing the objective reason to contract such a discharge. The Proposal contains no such similar provision. The AIFMD also permits a discharge of liability, under Article 21(14), where the law of a third country requires that certain financial instruments are held in custody by a local entity and there are no local entities that satisfy the delegation requirements found in the AIFMD, provided that certain conditions are met. The Proposal contains no equivalent provision. AIMA strongly recommends that the European Parliament and the European Council consider including a provision in the Proposal which would permit a depositary to contract a discharge of liability where appropriate. Failure to provide for this will mean that UCITS depositaries will be unlikely to take on investments where the law of a third country requires that certain financial instruments must be held in custody by a local entity, thus limiting the scope of investments that will be available for a UCITS fund to invest in, and potentially resulting in investors facing lower returns on their investments.

2. Depositary delegation of safekeeping functions to a sub custodian

AIMA's key points:

- AIMA considers that the conditions a depositary must meet to be authorised to delegate its safekeeping functions to a sub custodian should be no more onerous than the equivalent provisions of the AIFMD.

Article 22(7) of the Proposal sets out the conditions a depositary must meet to be authorised to delegate its safekeeping functions to a sub custodian. These conditions are to a very large extent similar to the equivalent provisions in Article 21(11) of the AIFMD. However, one additional condition has been included in Article 22(7) sub paragraph 3 (e) requiring that:

> *"in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among or realisation for the benefit of creditors of the third party".*

We support the policy aim of safeguarding UCITS assets as far as possible from the effects of the insolvency of the sub-custodian but, unlike the other provisions of Article 22(7), which set out a list of organisational tests the depositary has to meet, this additional condition in sub paragraph 3 (e) imposes an additional liability standard on top of that required by the AIFMD. We would therefore recommend that the wording is redrafted to reflect the organisational framework of the other points in the paragraph.

In its current wording, however, the proposed standard is very demanding and would potentially lead to situations where UCITS depositaries in certain jurisdictions would not be able to meet these requirements. The effect of the proposed wording would be that the depositary would guarantee the effectiveness of insolvency law to ensure an appropriate ring-fencing of financial instruments belonging to the UCITS in case of default of a sub-custodian located in a foreign jurisdiction. The effect would primarily be felt in respect of non-EU jurisdictions given the requirements to harmonise ring-fencing provisions in EU jurisdictions under Article 22(6). In non-EU jurisdictions, it will be challenging for the depositary to determine with a 100 percent degree of certainty in advance of appointing a sub-custodian how the insolvency rules in the jurisdiction of that delegate might apply. While we agree that a depositary should ensure that their local sub-custodians take all reasonable measures when setting up accounts to ensure that the UCITS assets are insolvency-proof, we note these efforts will be guided by advice given in local legal opinions which do not provide a guarantee in absolute terms. This raises concerns that depositaries will be unable to show with sufficient certainty that this requirement is fulfilled and may effectively exclude UCITS from investing in certain jurisdictions.

We consider therefore that proper account should be taken of situations where third country laws may not fully recognise the effects of asset segregation as being insolvency-proof, but on the other hand requires local custody of certain financial instruments. In these circumstances, we recommend a compromise. Instead of entirely prohibiting delegation of the safe keeping function, delegation should be made conditional upon the depositary taking additional measures to shield the UCITS' assets from insolvency and the residual risk should be duly disclosed to investors.

We also note that the word "assets" in Articles 22(6) and 22(7)(e) should be replaced by the words "financial instruments" to ensure an accurate cross references back to Article 22(5)(a) where "financial instruments" are the only assets capable of being held in custody.

We therefore recommend amending the wording in Article 22(7) sub paragraph 3 as follows:

"…

(e) is located in a jurisdiction which the depositary has assessed as having a system of laws providing that in the event of insolvency of the third party, financial instruments of a UCITS held by the third party in custody are unavailable for distribution among, or realisation for the benefit of, creditors of the third party other than the depositary;

(f) complies with the general obligations and prohibitions set out in paragraph 5 and Article 25.

Notwithstanding points (b) and (e) of the third subparagraph where the law of a third country requires that certain financial instruments be held in custody by a local entity and no local entities satisfy the delegation requirements laid down in these points, the depositary may delegate its functions to such a local entity only to the extent required by the law of the third country and only for as long as there are no local entities that satisfy the delegation requirements, and only where:

(a) the investors of the relevant UCITS are duly informed that such delegation is required due to legal constraints in the law of the third country and of the circumstances justifying the delegation, prior to their investment;

(b) the UCITS, or the management company on behalf of the UCITS, have instructed the depositary to delegate the custody of such financial instruments to such a local entity.

The third party may, in turn, sub-delegate those functions, subject to the same requirements. In such a case, Article 24(2) shall apply mutatis mutandis to the relevant parties.

For the purposes of the first to the fifth subparagraphs, the provision of services as specified by Directive 98/26/EC of the European Parliament and of the Council(**) by securities settlement systems as designated for the purposes of Directive 98/26/EC or the provision of similar services by third-country securities settlement systems shall not be considered a delegation of its custody functions ."

3. Remuneration

AIMA's key points:

- AIMA considers that the overriding policy objective in relation to UCITS remuneration policies is to ensure that the AIFMD and the UCITS regimes are aligned as much as possible.

The extension of requirements as to managers' remuneration has its origins in provisions within CRD III and the AIFMD, which build on the Financial Stability Board's ('FSB') Principles and further Implementation Standards for Sound Compensation Practices (April and September 2009), which were approved by the G20. The FSB's Principles, and the CRD III amendments, were a response to the financial crisis. The FSB Principles were "intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms" – a category in which, we submit, UCITS managers do not belong. CRD III was intended to deal with systemic risk originating in the banking and investment banking sectors (in particular, to address "excessive and imprudent risk-taking in the banking sector" - not in the asset management sector).

CRD III included very important proportionality provisions addressing the fact that even non-systemic institutions would fall within scope of the regulation and that the remuneration rules would apply to an extremely diverse universe of businesses outside the banking sector. However – and as this Consultation specifically references under section 2.4.4, in respect of proposed requirements of internal organisation and procedure - CRD III expressly provided that credit institutions and investment firms may apply the principles "in different ways, according to their size, internal organisation and the nature, scope and complexity of their activities".

As the Proposal acknowledges, UCITS were not a root cause of the financial crisis and the new UCITS regulatory framework should place significant limits on the risk UCITS can undertake, thus "limiting the extent to which misaligned incentives might lead to wider systemic problems". The Commission believes, however, that sound remuneration principles should apply to UCITS managers and should be consistent with those applying to AIF managers, banks and investment firms.

The Commission bases its proposals on these particular factors:

- new products and techniques used – more complex and sophisticated strategies and an increased use of performance fees (and undue risk being taken on);
- desirability of a level playing field for all sectors (banks, investment firms and assets managers), with no regulatory arbitrage and no scope for migration of more risky practices into the UCITS sector (in so far as the UCITS framework allows); and
- consistency among UCITS and other management activities within a group.

AIMA agrees that requirements for UCITS managers on remuneration should generally be consistent with and similar to those proposed for managers of AIFs, while allowing for differences and proportionality in application for various sectors of the industry.

Accordingly, we request that such features of the asset management sector be taken into account when considering principles for sound remuneration, allowing firms to tailor their remuneration policies appropriately and proportionally to their business model and risks. We urge proportionality in applying measures introduced to mitigate systemic risk, specifically in respect of firms which cannot be said to be systemically important and whose business practices and models do not pose the same issues as the banks and investment banks whose activities were the cause of the problems which regulators now seek to address.

4. Depositary passport

AIMA's key points:

- AIMA considers that a depositary passport for the UCITS depositary should be introduced given intention to fully harmonise depositary obligations in the manner similar to the AIFMD.

The current depositary rules are generic principles, which provide that national law will determine the precise nature of the depositaries' duties. This has lead to national divergences in the application of depositaries' duties and liabilities.

Since the Proposal seeks to fully align the national laws on UCITS depositaries and achieve harmonisation of the legislative framework, AIMA considers that now would be the time to also introduce a UCITS depositary passport. The requirement in Article 23 of the UCITS Directive that "a depositary shall either have its registered office or be established in the UCITS home Member State" currently prevents UCITS depositaries from both establishing themselves in various Member States and also from establishing themselves in one Member State and providing their services in a different Member States.

Article 49 of the Treaty on the Functioning of the European Union (the 'TFEU') requires that "restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited." Article 56 of the requires that "restrictions on freedom to provide services within the Union shall be prohibited in respect of nationals of Member States who are established in a Member State other than that of the person for whom the services are intended." Article 23 of the UCITS Directive may be justified. Whilst there remain national divergences in the application of depositaries' duties and liabilities, this restriction on the freedom to provide depositary services on a cross boarder basis could be justified.

Following the implementation of the Proposal, national laws relating to who can act as a depositary, depositaries duties, delegation of depositary functions and depositary liability will be harmonised. This will leave no scope for different national laws across the Member States as regards the UCITS depositary requirements. It therefore seems that now would be the best time to consider removing the regulatory anomaly in Article 23 of the UCITS Directive and adopting a UCITS depositary passport.

Furthermore, the creation of ESMA has strengthened the EU regulatory framework. ESMA has the powers under the regulation which establishes it (Regulation No (EU) 1095/2010, the 'ESMA Regulation') to ensure greater harmonisation in regulatory practices and supervision at the EU level. For example, the ESMA Regulation permits ESMA to adopt guidelines and recommendations with a view to promoting the safety and soundness of markets and convergence of regulatory practice[1]. ESMA also plays a role in ensuring convergence in supervisory practice[2]. For example, ESMA is required to organise and conduct peer review analyses of competent authorities, including issuing guidelines and recommendations and identifying best practices, in order to strengthen consistency in supervisory outcomes[3]. ESMA can also intervene where there has been a breach of EU law in relation to the UCITS directive[4]. The role of ESMA within the EU supervisory framework therefore adds further weight to the argument that there is no longer a justifiable reason for not permitting a UCITS depositary passport.

5. Eligible Assets

AIMA's key points:

- AIMA considers that the list of eligible assets in which a UCITS can invest should be expanded to include "commodity derivatives".[5]

UCITS funds are required to invest in instruments that are set out in the list of eligible assets in Article 50 of the UCITS directive, which includes transferable securities, money market instruments, units of collective investment schemes, bank deposits and financial derivative instruments. Derivatives on commodities were excluded from the references to liquid financial assets in Articles 1(2) and 19(1)(g) of Directive 85/611/EEC by Article 8(5) of Directive 2007/16/EC.

[1] See Article 9(2) of the ESMA Regulation and see also Article 16(1), which permits ESMA to issue guidelines and recommendations addressed to competent authorities or financial market participants in order to establish "consistent, efficient and effective supervisory practices within the ESFS, and to ensur[e] the common, uniform and consistent application of Union law."
[2] Other powers which may be of relevance are those such as Article 19, which gives ESMA the power to settle disagreements between competent authorities in cross-border situations and Article 29, which requires ESMA to "play an active role in building a common Union supervisory culture and consistent supervisory practices."
[3] See Article 8(1)(e) of the ESMA Regulation.
[4] See Article 17 of the ESMA Regulation.
[5] AIMA proposes that for this purpose, and to promote harmonisation among various directives, that the Commission consider adopting a definition that is the same as any final definition of 'commodity derivative' adopted in the context of MiFIR. The proposed definition is set out in Article 2.1.(15) of MiFIR (2011/0296 (COD)).

This treatment of commodity derivatives appears to be outdated and in contradiction with the investor protection concerns and the interest of investors in general. First, single commodity futures and options are among the most liquid instruments traded in financial markets. They are much more liquid than a great majority of transferable securities such as corporate bonds or small cap shares. Second, in the era of low interest rates and potentially increasing inflation, Europe's investors may need to have the flexibility of added exposure to commodity prices. If food and energy costs are rising, the retail investor may not have adequate means to shelter his or her savings against such shocks. Third, the investment strategies such as those pursued by commodity trading advisors ('CTA') and managed futures funds have proved to be popular when employed within the UCITS framework by using such tools as strategy indexes. However, it would be much more transparent and safe for the end investor if the CTAs were able to invest in the commodity derivatives directly as opposed to using a swap route based on a strategy index.

CTAs create well-balanced, diversified investment portfolios that have the potential to deliver returns and limit risks in any market environment. CTA managed funds are also are among the most transparent and liquid investment options. There appears to be no reason why a CTA should not be permitted to invest in a single commodity derivative so long as the UCITS diversification requirements are respected.

Restricting UCITS to only diversified commodities indices does not offer investors the benefit of experienced active management of commodities. By way of example, the underperformance of the Dow Jones-UBS Commodity Index (DJ-UBSCI) in relation to a more balanced portfolio was a result of the divergence of the crude oil benchmarks, WTI and Brent. For nearly 30 years these two benchmarks traded together, and then in 2011, they diverged by over $20 per barrel and could well remain dislocated for some time. The DJ-UBSCI only included WTI during that time. In delayed response to this, DJ-UBSCI added Brent as 33% of its crude allocation in its annual rebalancing in January 2012. However, CTAs were able to invest independently in the Brent single commodity index for the purpose of proactively avoiding the cost of the price dislocations as soon as those started to occur.

Where a UCITS offers appropriate risk diversification, active management of a UCITS should permit the use of single commodity derivatives. Commodity indices would not need to be diversified with respect to the 20/35% limit, so long as the exposure of the UCITS to the individual indices complies with the 5/10/40% ratios and satisfy the other criteria in respect of the construction methodology, regular rebalancing and publication of the index, subject to some appropriate method of classifying commodities to better track concentration limits.

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