



Time to rewrite the **rules**

Setting a realistic timetable for the EC examination of the Ucits depositary function is a must, writes **Samuel Sender**, of Edhec,



EC consultations on the Ucits depositary function and on alternative investment fund managers should be placed in the contexts of the single European market and of the Ucits directives for investment funds. The establishment of a single market requires harmonisation of the rules, meaning domestic laws and practices must be, as it were, born again.

The Alternative Investment Fund Managers (AIFM) Directive may seem a natural extension to the alternative universe of Ucits regulation, which has above all to do with funds meant for retail investors.

But the Ucits directives did not clarify the depositary role, and it was the Madoff fraud and the Lehman bankruptcy that highlighted the disparities in domestic regulations on depositaries and the degrees of protection afforded investment firms and end-investors. In some countries, but not in others, depositaries were obliged to return the assets for which Madoff served as sub-custodian.

The determination to protect investors and to harmonise laws inherent to Ucits regulation requires clarification of the role of the depositary and harmonisation of the obligations to which it is subject. Nonetheless, the crisis has above all shown that great risks, for which the asset management industry was unprepared, could come to pass, and for the EC the logical approach would be to do an in-depth study – to which the EC consultation contributes – of the non-financial risks weighing on those in the asset management industry and to identify the uncertainties as to responsibility and the possible absence of protection of investors or asset managers before drawing up proposals for directives.

Finally, any means of additional protection has a cost that can be likened to an insurance cost that must be borne by asset management firms and end-investors, an element that must be taken into account, as it has an impact on portfolio choices and thus on the investment market.

Protection from non-financial risks

The consultation on the Ucits depositary function assumes that unqualified investors are not ready to bear non-financial risks: “From the investors’ perspective, the market risk associated with their Ucits investments is the only acceptable risk they should have to bear.”

Even so, even in Ucits funds, a limiting ratio of 10%, also known as a junk ratio, enables investments in alternative asset classes and for all the holders of shares in Ucits funds implies the presence of a non-financial risk. In fact, certain asset classes cannot be held (certain classes of alternative assets such as investment capital or over-the-counter derivatives do not usually benefit from central clearing).

It would also be interesting to test the assumption that investors are not ready to take anything but financial risk. The distinction between financial and non-financial risk is

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sometimes vague or irrelevant: the default risk of a hedge fund or of the bankruptcy of a sub-custodian is inherent to investments in corporate debt and the operational risk of a party (for instance, that of the depositary with an unconditional and immediate restitution obligation) can be seen as default risk for its client (the asset management company or the end-investor).

For both alternative funds and Ucits funds that invest in alternative strategies up to the limit of 10% of their net assets, good diversification may offer the end-investor exposure to the risk of default of a hedge fund without a custodian of the same kind as the exposure to the risk of default of a portfolio of corporate bonds; in this case, meeting the objective of improved investor protection would depend more on controlling exposure to the risk (for example, through diversification) than on an unconditional obligation to return assets such as those held by the prime broker and that cannot be directly controlled by the depositaries.

The existence of this risk calls again for accurate information on the degree of total risk (financial and non-financial) borne by investors. The possible ability of Ucits funds to invest in alternative strategies also points to the need to spell out the bounds of the depositary’s obligation to return assets.

Depositary control and safe-keeping

The regulations that apply to the depositary may need to undergo total reworking rather than mere modification. In some European countries, these regulations are an outgrowth of bank law: in France, for example, the restitution obligation can be considered a legacy of the Civil Code, that is, of a period in which safe-keeping involved deposits of deeds ▶

of ownership and valuables in the safe-deposit boxes in a bank.

For the deposits of valuables, the unconditional restitution obligation is of course comprehensible, including in the event of an unnecessary sub-custodianship. But this obligation is unsuitable for derivatives or for delegation to a prime broker or even, in all likelihood, for the entire set of assets that must be managed actively.

Derivatives cannot usually be safe kept, in the ordinary sense of the term. And what of the custodian's obligations in the event of physical delivery, if, for example, commodity futures are held to term? Must the custodian take delivery of a few thousand tonnes of coal for an investment fund in order to ensure that he is capable of restitution?

In the case of private equity, the shares are registered in the issuing firm's accounts, and the depositary has only partial means of control but no means of safekeeping.

For alternative products, safekeeping may be possible, but the term needs significant reexamining. Take the safekeeping of wine, for example: it requires controls of temperature, humidity, luminosity, and it is better to control these factors through sub-custodianship in appropriate places than to favour the unconditional restitution obligation, which would imply safekeeping in a bank strongbox. Here, the means of safekeeping are more important than the restitution, and regulations should be modified to deal with the realities of our modern world.

For these products that must be managed, one can see the importance of leaving the manager an ample choice of means of safekeeping and, at the same time, of lessening the responsibilities of the depositaries.

In any event, the texts reveal a great vagueness on the limits of the liability of each party (asset management firm and depositary). The end-investor, even if he is qualified, does not always have a clear view of the risks and protection mechanisms at play in the management and safekeeping of the assets resulting from his investments. Here, we emphasise again that the degrees of protection from these non-financial risks will vary greatly not only as a result of local regulation (beyond a possible common European base), but also as a result of the type of assets and the contractual commitments made by the depositaries and custodians.

In short, the regulation of risk must go hand in hand with regulation of the disclosures of

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risk. This transparency of risk will make it possible to avoid the temptation of a regulatory race to the bottom. Above all, it will make it possible for clients to make informed choices. Regulation of depositaries and of investor communication should spell out the asset classes for which the depositary cannot be held to an obligation of restitution and for each Ucits or alternative fund the percentage of assets concerned. This pragmatic approach to information is ultimately more to the client's advantage than is an automatic restitution obligation expressed too vaguely to take into account the different asset classes, a vague obligation that, at one and the same time, would be subject to interpretation in national law and hard to enforce Europe-wide.

Issues with sub-custodianship

Alternative assets may provide a perfect illustration of the issues of custodianship, but there are similar issues for conventional asset classes and Ucits funds. For international funds, most depositaries, including the largest global depositaries, resort to sub-custodianship agreements.

The workings of the current system of depositing managed assets imply thousands of billions of euros entrusted to sub-depositaries. The oversight and risk management obligation is facilitated in the case of conventional assets by the possibility of demanding a transfer of assets in the event of a fall in the sub-depositary's rating. This is not necessarily the case in more exotic countries or for the above-mentioned alternative investments. In these cases, the depositary is committed by the client's choice of the means of custodianship and/or identity of the sub-custodian, so logically the depositary cannot assume all responsibility for the return of assets. In addition, it would be excessive to demand the unconditional and immediate restitution of assets in sub-custodianship – as is the case for depositaries in France, where the bankruptcy of a large American depositary bank and the possible inability to return the assets immediately, before the liquidation of the bank, would have immediate repercussions on many French depositaries and their parent banks. In any event, the depositaries should have an obligation to provide information not just to the asset management firm but also to the end-investor, for example, through clarification of the prospectus and periodic verification of the information sent to them.

Pricing of protection

The Lehman and Madoff cases highlighted the risks and drew attention to the pricing of the services and guarantees offered by depositaries. Depositaries noted that ensuring the unconditional return of assets out of their control was equivalent to insurance coverage and that it should be priced as such. The analogy with the pricing of an insurance risk is all the more appropriate in that some banks do indeed buy operational risk insurance. Insurance companies, now more aware of the risks of the asset restitution obligation, are raising their prices. That will very soon be the case above all in France, where immediate and unconditional restitution was clarified and confirmed, an arrangement better understood by the insurers or reinsurers that insure (or reinsure) against this risk. Before making any proposals for directives, the European Commission should, as for any study of public policy, consider different forms of protection and their costs. In addition, the insurance market is usually characterised by a minimum coverage required for the public good and optional complementary insurance. The

market for investor protection by depositaries should also involve optional component guarantees (beyond a minimum base that may include the inversion of the burden of proof for conventional products).

Risk quantification and transparency

A great diversity of levels of protection offered by depositaries both to asset management firms and end-investors will survive even after the establishment of a minimum requirement. Beyond the minimum that the European Commission should require, there may be divergences from one country to another in the transposition into national law as well as in the organisation of domestic markets; in addition to regulatory arrangements, depositaries may offer contractual services associated with transfers of liability. So it is essential for asset management firms and investors to be informed of the degree of risk they must bear, all the more so as knowledge of operational risk is not sufficiently widespread among either asset management firms or end-investors, including the so-called qualified investors, characterised by their knowledge of financial instruments and risks but not necessarily of the non-financial risks in the management chain.

It is clearly more important to quantify the degrees of risk offered investors and to regulate communication on these risks than to spell out the minimum requirements depositaries must meet. Information on non-financial risk is indeed inadequate, and it does not make it possible for an investor to assess the non-financial risks he takes and to rank funds by the degrees of protection offered, because these risks are not quantified. We support the intention of the AIFM directive proposal to make sure that investors are informed of the identity of the depositary and of its obligations in the event of losses, as well as of the identity of any sub-depositaries, but this information is not of a quantitative nature and does not make rankings possible. This issue of the quantification of risk is relevant to the measurement, control, and reporting of financial risk as well, as emphasised by the Committee of European Securities Regulators (CESR).

In this context, the establishment of a common minimum requirement spelled out by a European depositary directive cannot, given the divergences that will remain in domestic regulation, in practice, and in contractual terms, take the place of the use of tools that make it possible to qualify and to quantify the

degree of protection offered investors by service providers.

Study of risks and regulations

In its consultation, the Commission points out that protecting investors from non-financial risks is made difficult by the changes in products and techniques: "Since 1985, the European asset management industry has changed. Financial products now eligible for Ucits portfolios are more complex and are often registered outside the EU in third countries and emerging markets jurisdictions."

These circumstances may justify clarification of the responsibilities of depositaries and even a strengthening of oversight obligations, but these new tools require above all a study of the large non-financial risks and of the regulations of those in the management chain, a study that should take into account modern asset management instruments and techniques.

The responsibilities of the depositary and the costs associated with the obligations that it must meet cannot be analysed without a parallel examination of the changes to the texts governing the parties and products involved in European investment fund

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business. The impact studies and the CESR opinions have rarely taken into account the consequences for depositaries and, more broadly, for back offices. Whether it is the creation of the category of sophisticated Ucits or making more assets eligible for Ucits, changes to European law often assume that 'stewardship' will follow. The Madoff fraud suggests that it might well be worth ensuring that stewardship really does follow. So we think that a specific study of the world of alternative management would reveal the limitations of current regulation, of the restitution obligation, for example. Such a study would make it possible to examine the suitability of the regulation for modern financial instruments and asset management techniques. In addition, a broader study of the entirety of the fund management industry is needed. It seems to us that the study should include a number of elements.

A description of the functions and role of main parties involved in the management of investment funds in certain key countries of the European Union is needed.

The legal rules and the consequences of the legislation on the definition, limits, and obligations linked to the businesses of service providers in the fund management value chain has to be considered.

Also there needs to be an assessment of the risks to which the major parties are exposed, with an approach based on the analysis of responsibilities, as well as with an analysis of the major historical cases of large losses in the international asset management industry.

In the wake of this study, it will be possible to make proposals for improved liability rules. These proposals should naturally be made available for industry evaluation, with a call for reaction to the proposals, as the European Commission is doing with the AIFM directive, and a more detailed study making it possible to evaluate the practices of depositaries as well as possible changes to the profession as perceived by wealth management firms (the tension between a need for greater protection and the implications in terms of pricing) and, if possible, by end-investors. **fe**

• *Samuel Sender is applied research manager at Edhec-Risk*

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