European depositary regulation

Striking the right balance?

Ines Cieslok
Vice President
& Senior European Counsel
State Street Bank GmbH

Dr. Sven S. Kasper,
Senior Vice President & Director EMEA,
Regulatory, Industry and Government Affairs
State Street Bank & Trust

In response to the financial crisis, the G20 countries made strengthening the stability of the financial system a primary focus of their regulatory reform regime. Policymakers in both the US and the EU quickly realized that improving market conduct and strengthening investor confidence were also key to restoring public trust in the industry and in financial markets in general. As a result, the financial services industry has been confronted with— and has to adapt to— the persistent flow of regulatory change within their new "business as usual" environment.

As part of the effort to strengthen investor protection for investment fund investors in the EU, the AIFMD (Alternative Fund Managers Directive), which also covers previously unregulated fund structures, and the review of the UCITS Directive (UCITS V) were initiated. Both initiatives, amongst others, introduce increased requirements for depositaries, in particular, a strict liability regime for financial instruments held in custody by the depositary on behalf of the AIF/AIFM or UCITS. While the AIFMD has been fully implemented, the revised UCITS framework will become applicable on 18 March 2016, with the implementing measures currently being finalized.

In light of the discussions around the details of the depositary liability and the depositary obligations, in the context of the UCITS V implementing measures, two questions arise:

1. Will the implementing measures achieve the regulatory objective of investor protection?
2. Are the costs of implementing the measures proportionate to the achievable revenues in this sector?

Harmonization to achieve investor protection

With UCITS V becoming applicable on 18 March 2016, at the time of writing, the Level 2 implementing measures are being finalized by the European Commission (EC). These implementing measures will contain important details on the depositary's duties and obligations set out in the Directive as well as more details regarding the liability regime and the elements that are required to be included in the depositary contract. When drafting the implementing measures, a fundamental decision the EC has to make is whether to use a directive or a regulation. In general, and as part of its efforts to achieve a higher degree of harmonization across the EU, the EC increasingly uses regulations (i.e., directly applicable EU law) instead of directives, which require implementation into national law.

Greater harmonization is a basis for a consistently applied investor protection scheme and also helps to avoid regulatory arbitrage between EU member states. The downside, however, is that regulations are more rigid and provide less flexibility to accommodate different national market standards and practices that have evolved in the various EU member states.

Such differences can be observed in the tasks performed by European depositaries in the various member states as well as with regards to specific functions, such as the Transfer Agency function.

Different processes and functional responsibilities

The responsibility of the Transfer Agency function in the asset management business is a good example to demonstrate the difference in responsibilities across EU member states. For example, in Germany there is no owner register for regulated securities investment funds to record beneficiary information. The fund shares (issuance) are reflected in a global note, which is deposited with the German CSD (Clearstream Banking Frankfurt). Normally, the depositary receives the orders (buy or sell orders) from investors via their respective custodian bank and provides for the mark up/down of the global note, accordingly. The administration of fund shares is, therefore, an activity performed by depositaries in Germany. By contrast, in Ireland or Luxembourg the fund or its manager appoints a Transfer Agent to maintain a register of fund shares.

In Germany, the issuance practice and the mechanics described above (via securitization) ensures that fund shares are fungible and eligible for safekeeping. This is not the case in other member states. The difference in approach causes significant challenges when implementing the AIFMD or UCITS V. It is unclear if fund shares issued under either of these models need to be treated equally or if the depositary's liability for the loss of assets should be determined by the particular kind of registration. A clear understanding about the different processes in all member states is therefore a pre-condition to ultimately achieving effective and fair harmonization.

National gold-plating is counterproductive to achieving objectives

Going beyond these functional differences, another challenge for harmonization is the inconsistent approach of national regulators to implementing directives into national law. For full harmonization to be achieved, it is necessary not only to harmonize certain functional differences at a European level, but also to encourage consistent national implementation of European legal acts. While such differences in implementation to some extent accommodate for certain national specificities, there is a risk that the landscape will become more fragmented overall, making it more difficult to have harmonized processes and procedures across the EU.

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The absence of such harmonization also makes the introduction of a depositary passport unachievable. The latter would represent the completion of the single market for depositaries, as it would introduce the possibility for depositaries to offer their depositary services on a cross-border basis in the EU. Currently, a fund's depositary must be located in the country where the fund is established.

Change of liability in the interest of investor protection

With the AIFMD, the liability for a loss of financial instruments held in custody has fully shifted towards depositaries. This shift has now been replicated in UCITS V. However, this new regime should not be viewed as eliminating the responsibilities of all parties in the investment process. Strict depositary liability only applies to financial instruments that can be held in custody following trading decisions of funds and their managers. It is therefore important for funds to ensure that appropriate due diligence and responsibilities are considered at the beginning of the process. However, it is unlikely that these considerations will change the already fixed perspective of regulators on the depositary.

More important to consider is the impact that the significant change in depositary responsibilities and the related implementation costs and risks will have. How will depositaries address the challenges resulting from the stricter liability regime and the increased administrative burden following the extended duties and obligations, including with regards to the markets they offer and their fees? This question is surely becoming more critical, as the economics of this business are being reviewed by organizations where the depositary business is not core to their operations in light of the increased liability and a general consideration within banks as to the most efficient allocation and use of their capital.

At this stage, it is too early to draw a conclusion as to whether the right balance has been struck. Much will depend on the details of the final level 2 measures and even more on how the individual EU member states will implement the European rules and the extent to which they create additional requirements.

All market participants surely have an interest in ensuring the right balance is struck between regulatory objectives and the ability for service providers to deliver cost-effective services; room for improvement is warranted, especially at the current early stages of implementation. The overall importance of the final outcome should not, however, be underestimated, as it will be a contributor to the future success of the UCITS brand, both within and outside the EU.