HFMWEEK

SPECIAL REPORT

UCITS 2013

CHALLENGES
Updates to the guidelines provide food for thought for managers

COMPETITION
The AIFMD's debut brings new options in onshore fund structures

FUTURE VARIANTS
Divisive plans for Ucits V and VI directives making steady progress

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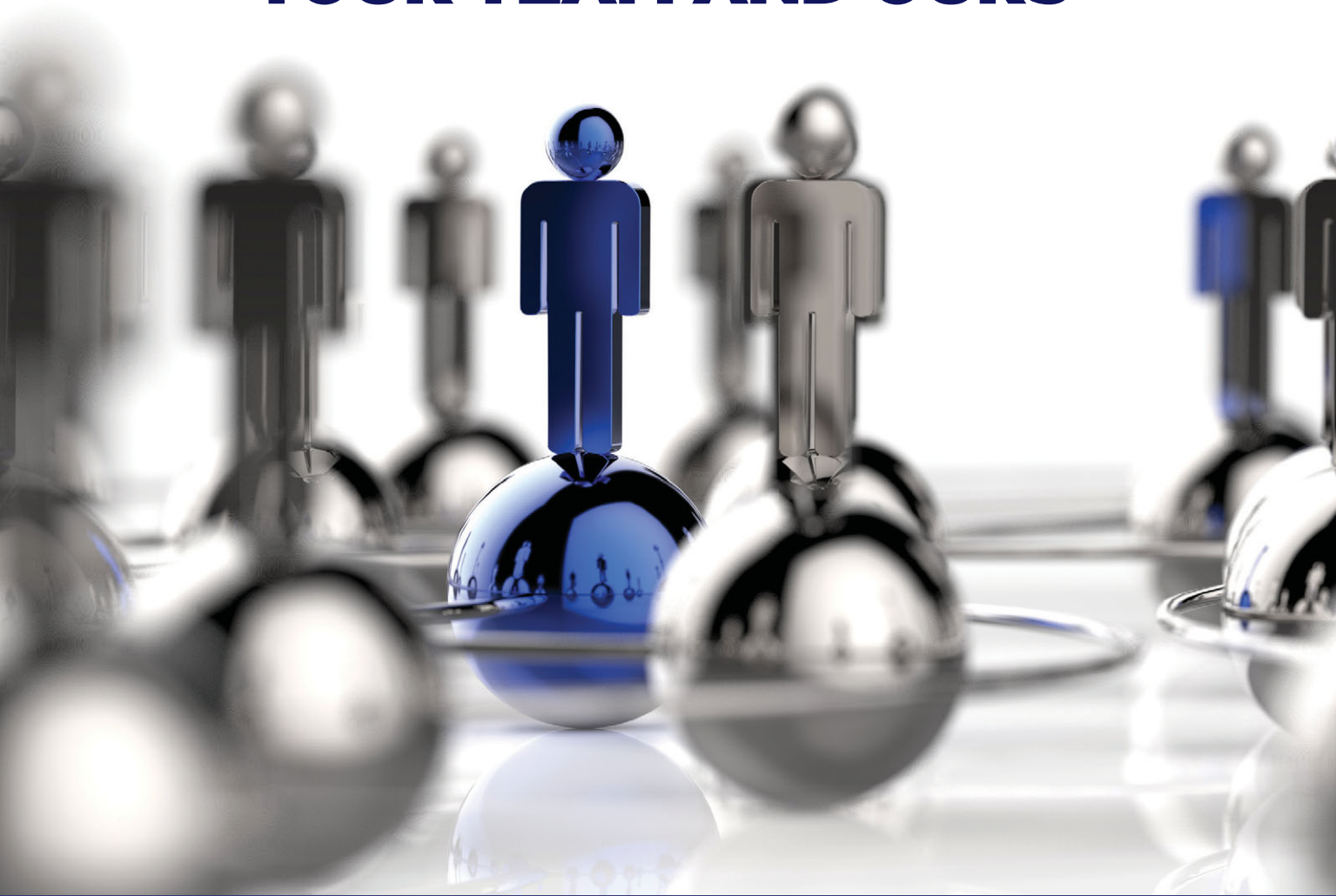

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We pursue a philosophy which emphasises both study and pro-activity. We seek to identify trends in the international commercial and financial markets leading to opportunities for Malta once translated into tangible form. It is no surprise that we have been consistently at the forefront of local legislative initiatives and have provoked on several occasions over the years major legislative change in many fields, not least in maritime, ship finance, banking, aviation, trusts and investment services.

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PASSPORT INVALID: ENTRY DENIED

DR. DAVID BORG-CARBOTT AND DR. CHRISTOPHER MALLIA, OF GANADO, DISCUSS THE FUTURE ARRIVAL OF UCITS V AND THE IMPLICATIONS OF PASSPORTING DEPOSITARY FUNCTIONS

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is a senior associate within GANADO Advocates' investment services and funds team with particular focus on safekeeping of assets and fund custody.

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Ucits V aims to align the Ucits brand with the AIFMD rules and to further bolster the regulatory architecture for investors in mutuals, seeking to push the Ucits wrapper within Europe and capitalise on realised successes in Latin American and Asian markets.

Its proposed remuneration restrictions, set to cap bonuses for fund staff and cajoling them into getting their skin in the game, have sparked much interest. Perhaps eclipsed by the AIFMD's depositary rules and liability implications generally, Ucits V's provisions for depositories did not garner the same level of attention.

Instead of focusing on what Ucits V does provide for, we would rather shed some light on one area where the Commission has persistently fallen short – allowing the passporting of depositary functions across the single market.

Currently, Ucits depositaries cannot avail from a European passport. The Ucits Directive prescribes that depositaries shall either have their registered office or be established in the Ucits's home member state.

Undoubtedly, the passporting of depositary functions carries potential implications for myriad stakeholders and necessitates prudent and careful assessment. The Consultation Document of July 2012 on product rules, liquidity management, depositary, money market funds, and long-term investments (Ucits VI) expressly raised the issue, indicating willingness to acknowledge the implications of a cross-border passport for depositary functions set out in the Ucits Directive for different stakeholders.

Industry players have long debated whether Ucits should be limited to using depositaries located in the same jurisdiction as the fund. Opponents have raised familiar arguments. From necessitating elevated levels of co-operation and co-ordination between competent authorities, to concerns about the viability of further extending Esma's oversight functions.

Talk of systemic risk and exacerbated contagion risk have also featured, but the fact that no EU fund has received state support over the course of the financial crises over the last five years makes these assertions sound hollow. Concerns on elevated costs – due to the need to report to a plurality of competent authorities depending on the nature and extent of passported activities – are admittedly not without merit.

These 'issues', however, should not impede the inevita-

ble. Given that these arguments are often fielded by exponents of the single market – at least insofar as regulation and oversight are concerned – the opposition to passporting of depositary functions should wane.

Depositaries operating within the single market must be credit institutions or, with Ucits V, investment firms. Both are extensively regulated by EU legislative instruments. Accordingly, protection of investors, the fulcrum of the Ucits brand, is already indirectly provided for by regulations attaching to the eligibility of those offering these services.

From a competent authority's perspective, passport rights for depositaries will undoubtedly increase costs of supervision, co-ordination and sharing of information. However these additional costs may be counter-balanced by the potential competitive growth within the industry. Similar cross-border supervision already exists in the context of the management passport introduced by Ucits IV.

For our part, we are of the view that passport rights for depositaries are a natural step in the evolution of this market. Europe needs to look at the provision of custody services generally as a single market in its own right. The motives are clear. The MiFID II proposal has more latitude than MiFID, covering more firms and a broader range of products. Custody services are set to become a 'core' investment service instead of an 'ancillary' service, and thus passportable in terms of MiFID. Either there is no unified approach regulating this service within the common market, or the dislocation is deliberate. Neither is desirable.

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Both the AIFMD and proposals in terms of Ucits V sought to iron out inconsistencies in the rules applicable to depositaries and the manner in which their functions are carried out with respect to AIFs and Ucits schemes. Ucits V also effectively addressed issues of non-harmonised depositary liability, killing another common issue. If this area is ever to be effectively harmonised a new framework, reflected in the Ucits V proposal, should deal with eligibility requirements, the role, functions and obligations of the depositary and liability issues, also including liability when certain functions are delegated to other depositaries. Promoting the freedom of movement of market players cannot but foster a more competitive market, and importantly, hammer a nail into the coffin of an increasingly outdated requirement of a "jurisdictional" anchor.

The custody function does not exist in isolation. As market participants become more agile and operate across the common market, regulations should seek to encourage this agility. The EU needs to get this right in the short term, to take a step back, to look at the custody function as a market in its own right and not as one parasitic on "primary" financial activity, and then to regulate for a single market for custody services.

A regulatory framework for the future cannot but recognise the depositary market (not only of Ucits funds but also of AIFS and private clients) and promote the development of this market, rather than allowing for uncoordinated regulation interspersed among a plurality of directives. The current approach leaves the door open to conflicts, inconsistencies, and opportunities to arbitrage these to the detriment of the common market and its participants.

Undeniably the regulatory architecture will need to be robust; formulating a unified approach to the provision of custody services will need due consideration, and will have its day.

In the short term, the need for adequate supervision is key for a functioning mutuals market and the success of the Ucits brand. The need to cater for the particular risks carried by those undertaking depositary functions in the Ucits context could be surgically addressed without major overhauls.

Economic or regulatory rationales for abstaining from applying the mutual recognition principle to the depositary function are weak at best. The depositary passport will boost competition in the field of depositary services, promote efficiency, and can serve to mitigate costs for the EU's internal market for mutuals.

Failure to allow passporting is no longer an oversight. It sends a clear message to member states without developed depositary industries of their own: that depositaries in that state should not compete (to the extent they can) with those in established jurisdictions of the European mutual fund market.

Moreover, the failure to allow for passporting endorses inefficiencies and higher charges applied by established depositary providers, simultaneously undermining the need for them to be competitive. This is detrimental to funds established in a member state and prejudices the interests of the investors whose interests promoters of Ucits wax lyrical about protecting and promoting.

It is worth noting that Malta successfully negotiated a derogation until 2017 from the AIFMD requirement for the depositary function to be satisfied in the same member state as the AIF, which has the effect of creating a de facto "passport" for depositary services into Malta, albeit isolated and limited to licensed banks. Future passporting of depositary functions might be spurred by Malta's de facto AIFMD depositary passport.

The effect of persistent failure to enable the passporting of the depositary function is an atavism. The single market has moved beyond jurisdictional limitations on many fronts. There are no reasons for exceptions to be made here. ■