



The current financial crisis and the alleged Madoff fraud have revealed risks and gaps in investment products regulation and supervision that need to be solved at the EU and possibly global regulatory levels with clarified and more harmonized responsibilities and liabilities along the fund value chain. Assessing

further harmonisation opportunities of the framework of non UCITS investment products should also be a major objective for the Commission following a clarification of the needs of retail and institutional investors.

**1. Clarifying responsibilities along the fund value chain and launching a harmonization effort across Europe are major priorities:**

The on-going financial crisis has shown that evolutions may be required in the risk management practices of fund market players and in prudential standards applied to them. Asset managers and their administrative agents have traditionally managed strictly operational risks related to eg order execution or valuation. But other risks such as counterparty risks (eg with the default of Lehman), credit risks and particularly liquidity risks with funds offering often daily or weekly NAVs potentially faced with illiquid assets and important withdrawals (eg in the case of some monetary funds) have been more strongly emphasized during this crisis. These issues should be taken into account by supervisors and regulators in a coherent way across the EU.

More recently effective risks have also come to light, through the Madoff affair<sup>2</sup>, in the investment fund processing chain and more specifically in the role played by depositaries in the US but also in Europe. Indeed, several UCITS funds managing around 1.6 billion euros had delegated their investment management to B. Madoff's company and their depositaries had also delegated the safekeeping of the assets to the same company which was governed by American regulations. This type of set up resulting in the same company performing investment management and depositary activities is prohibited within Europe.

The legal battles that are currently underway reveal major uncertainties over the ultimate liability for the assets entrusted by European investors to these funds, and the conditions under which delegations were carried out with B. Madoff's company. This uncertainty stems in particular from different transpositions of the UCITS Directive's provisions at national levels:

- Although the UCITS Directive stipulates that depositaries - which are in charge of the oversight of funds and the safekeeping of assets - have final responsibility for the assets safekept in UCITS funds in the EU, the way in which this responsibility is expressed and the corresponding obligations vary from one country to another<sup>3</sup>.
- Similarly, rules governing the delegation of asset safekeeping to sub-custodians vary across the EU due to different interpretations of the general terms of the Directive

The due diligence processes undertaken by the EU management companies involved in the Madoff case also appear to have been insufficiently strict and consistent concerning in particular the companies to which the investment management was delegated to and the auditing firm used.

The inconsistent transpositions of the UCITS III Directive across Europe have been highlighted by Eurofi and the industry in the past but also by the Commission in its 2004 Communication on the subject<sup>4</sup>. Proposals to adjust definitions at Level 1 at the occasion of the UCITS IV review were unfortunately not retained by the Commission in 2008 due to insufficient visibility on the expected economic impacts, but should be a major priority for the next review of the UCITS Directive or could be introduced in another EU legislative framework.

CESR and the European Commission are at present conducting an official review of the manner in which Member States have implemented the relevant provisions of the UCITS Directive and how responsibilities and liabilities of depositaries are defined having regard to national civil law. Following the result of this assessment, CESR should ideally be able to implement short term solutions to move towards effective harmonization of responsibilities and liabilities of depositaries and of management companies across Europe.

Two main options appear to be possible at EU level for UCITS funds in particular, to solve the issues revealed by the Madoff fraud.

<sup>1</sup> This Eurofi paper do not engage the Chairmen of Eurofi

<sup>2</sup> This fraud concerns specific alternative funds authorised and managed in the US. At the same time, there are several European funds set up in Europe following the UCITS framework for which the custody and the management were delegated to Madoff company in the US. These EU funds received investments directly from institutional or wealthy clients and were part of several funds of funds authorized in the EU.

<sup>3</sup> An obligation to restate assets to the investors in case of default applies to depositaries in the EU but in most countries it is only valid if the depositary has not performed all the required controls and it is defined contractually between the management company and the depositary. In France for example the expression of the responsibility of depositaries for UCITS funds is more precise and constraining: an asset restitution obligation is clearly spelled out and not limited by any conditions. In addition this restitution is required to be immediate ie before the bankruptcy process has been finalized.

<sup>4</sup> Communication from the Commission to the Council and to the EU Parliament – 30.03.2004

One is to harmonise the depositary's responsibilities by aligning them based on the most demanding standards at European level, as recently suggested by Mrs. Lagarde, with total responsibility demanded from the depositary. This would offer the benefit of ensuring strong protection to investors by requiring custodians to return the assets invested to them, whatever the circumstances and defaults seen. Several issues nevertheless need to be considered for this solution to be feasible:

- The restitution of the assets by the depositaries does not necessarily need to be immediate, even if it is unconditional, because large exposures outside Europe may lead to create systemic risks in the market in case of default.

- A downside with this solution is that all the responsibility is taken on by the depositary and not shared with other players such as the management company. This solution should therefore be considered only if it is accompanied by measures allowing depositaries to take on these responsibilities under viable economic and legal conditions and to have real means to conduct their oversight missions in all circumstances. This probably requires reviewing the way revenues and costs are allocated across the value chain to make sure that depositaries get adequate remuneration for the risks they manage. Different solutions were also suggested by the market players consulted:

- Many players consider that oversight and asset safekeeping functions must be maintained in combination for depositaries to be guaranteed to have access to information on the assets held and on the transactions in the fund.
- Some players believe that possible delegation of the entire safekeeping to a sub-global custodian should be more strictly controlled or possibly prohibited<sup>5</sup>.
- In addition evolutions in the contractual arrangements between the management company and the depositary could be required when implementing measures for the management company passport in the Level 2 text of UCITS IV.

- Fund rules outside the EU should also be taken into account leading potentially to specific rules to limit the liability of depositaries in case of delegation of asset safekeeping outside Europe. Indeed some countries do not impose a segregation of asset management and safekeeping activities – at least not for all types of funds.

- Specific rules should be defined in case one or several sub-custodians default following a fraud of which the depositary is not aware and that cannot be detected by its control processes.

- Specific rules may need to be defined for funds of funds since depositaries cannot easily verify the information provided by the registrars on the shareholding of the underlying funds

- The differing statutes and capital requirement rules followed by depositaries across Europe could also be streamlined in light of the experience of the Madoff fraud and of the financial crisis.

An alternative to be looked into involves maintaining a balanced breakdown of responsibilities between the depositary and the management company on the scope of each one's activity, based on clearly separated responsibilities and clearly established contractual guarantees and conducting a harmonization effort across the EU on this basis. In this case liabilities could be shared between the asset manager and the depositary depending on the origin of the default.

This would probably require reviewing the prudential standards that asset management companies follow at present across the EU and proposing solutions for management companies to be able to face up to their commitments in case of default. Several ideas have been recently suggested to improve the safety of the funds market (such as reviewing capital requirements of management companies according to the level of risk and to the evolution of products, creating a guarantee fund at market level, better structuring the borrowing / lending of securities...). These ideas need to be completed, further specified and tested.

These different measures applicable to investment funds should not be developed in isolation and should take into account comparable products sold to similar clients (ie notes, certificates, etc...), particularly retail ones and competing legislations as much as possible.

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<sup>5</sup> For example obliging global sub custodians to comply with the depositary local regulation or putting in place a harmonized template or an industry code of conduct. When safekeeping is delegated to a sub global custodian these providers do not always take the responsibility for the assets at present. And since depositaries are not always able to select sub-custodians or to have access to the network of sub-custodians used by a global sub custodian they may not be able to exert controls correctly unless they maintain a duplicate custody system mirroring the assets safekept in certain cases.

## **2. Further harmonizing regulation for the most common non-UCITS funds and for comparable investment products is another potential source of improvement:**

Additional measures seem necessary for investment products or non-UCITS funds which do not benefit currently from a unified regulatory framework in Europe (e.g. hedge funds, real estate or private equity funds, certificates or notes, etc.).<sup>6</sup> Many such products have been developed under domestic legislation and some of them are sold to retail investors, either directly or within wrappers. Some products such as certificates or notes can be passported under the Prospectus Directive. These products are covered by the MiFID distribution rules or the rules for intermediation in insurance, depending on their characteristics. But these distribution rules are not sufficient to guarantee protection of the investors. Indeed they give no guidelines or safeguards on the products themselves or on the information that needs to be provided by producers to the distributors and investors.

For many years now, the asset management industry has been calling for European-level legislation for some non-UCITS funds<sup>7</sup> in order to facilitate the development of common standards and cross-border distribution to retail and wholesale investors both within Europe and outside of the EU. Calls have also been made for establishing a level playing field in terms of regulations with comparable investment products. Promoting greater harmonisation for the rules could further strengthen investor protection and facilitate the supervision of such products. However, this must be preceded by an accurate assessment of retail and institutional investors' needs and of the safeguards required by each type of investor to identify the products that really require EU legislation and for which it would be beneficial and to define an appropriate and suitable regulatory framework.

Furthermore, in light of the gradual globalisation of the markets, facilitated by the possibilities for delegating functions (eg investment management, asset safekeeping...) outside of Europe and the development of open architecture distribution<sup>8</sup> and funds of funds, minimal security rules should be elaborated on a global level possibly by IOSCO<sup>9</sup> for all investment funds, including hedge funds, through a clear segregation of responsibilities between the asset manager and the depositary, and the appointment of an independent depositary in charge of the supervision and safekeeping of assets where this is not yet systematic (eg as in the US). This process could potentially be initiated at the occasion of the G20.

Specific – and, insofar as possible, harmonised – prudential rules could also be proposed for management companies marketing these types of product and, in priority, as also proposed by the G30, for hedge funds representing systemic risks for the European market.

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<sup>6</sup> Several consultations have been conducted by the Commission on these different subjects over the recent years with regard to evaluating legislative opportunities at EU level for different categories of non-harmonized funds (open-ended real estate funds, private equity funds, hedge funds, ...), to possible regulatory level playing issues between UCITS and competing investment products and to opportunities to develop a EU private placement regime. But no formal decision has yet been made at this stage except for not including new asset categories in the UCITS IV reviewed package, which some players had advocated eg for open-ended real estate funds or funds of hedge funds. These issues will need to be further assessed in light of the lessons of the current financial crisis

<sup>7</sup> Eg real estate funds, fund of hedge funds, ...

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<sup>8</sup> ie Funds distributed by a company independent from the fund manager or fund promoter

<sup>9</sup> This could possibly be undertaken at the initiative of the FSF. These rules could later be incorporated into a EU Directive.