SGSS European Roadshow

Such has been the pace of regulatory change in recent years that there now appears to be a degree of overlap between UCITS V and AIFMD as European regulators and the European Commission commit to enhancing investor protection, not just in UCITS funds but all alternative investment funds. With UCITS V now live, there are areas of common ground with AIFMD, principally regarding the depositary liability sanctions regime and the remuneration regime.

To canvass a range of different opinions on UCITS V and AIFMD, and the extent to which these two regulatory bodies are moving towards a single orbital path, Societe Generale Securities Services undertook a European roadshow throughout March, hosting panel sessions in the following five European cities:

- Luxembourg
- London
- Milan
- Paris
- Zurich

This second section will now present the key findings that arose from the panel sessions.

QUESTION 1 - How does the regulatory framework impact the (UCITS) brand?

When AIFMD was introduced on 22nd July 2013 it aggregated all non-UCITS funds under one regulatory framework. This was done to protect the UCITS brand and ensure a degree of clarity when distributing UCITS funds globally. When one looks at the distribution of funds across Europe and internationally, UCITS funds are well known. In Hong Kong alone some 1,700 UCITS funds are distributed.

In China, the UCITS V Directive has been translated into Chinese. Speaking in London, Karen Bowie, Senior Adviser, Product Regulation at the Investment Association, confirmed that a number of Chinese asset managers were interested in the UK, leading the Investment Association to translate its UK regulatory guide for UK UCITS and other UK-authorised funds into Chinese.

"The UCITS brand has been a phenomenal success. According to EFAMA statistics there are now EUR7.89tn in UCITS assets," said Bowie. "I think in 20 years' time we could well be talking about AIFMD as a success story in the same way that we talk about UCITS today."

Most importantly, in light of AIFMD, the alternative UCITS segment is the fastest growing segment today in the UCITS space and it's not hard to understand why the brand has been so successful.

“Firstly, UCITS funds provide flexibility and affordability to fund sponsors to provide multiple services across multiple client segments with multiple value propositions. Secondly, UCITS V is set to further enhance investor protection and this is helping the UCITS brand to offer an unrivalled framework for asset managers to distribute products across Europe,” said Antonio Napolitano, Head of Strategic Product & Marketing, Pioneer Investments in Milan.

The introduction of the KIID under UCITS IV was viewed as an important development during the SGSS European roadshow, confirming that the UCITS brand intended to remain a retail-focused offering. All new provisions stemming from UCITS IV and UCITS V reaffirm that there is a strong intention to monitor and provide comprehensive oversight and that transparency has been conceived with retail investors in mind at all times.

This is where regulation can enhance a brand and allow it expand. With each iteration of the UCITS Directive, one has been able to do more; i.e. the Management Company passport, Master Feeder structures, KIID document etc.

But one has to be careful that there isn’t too much regulation. The challenge in Europe is to stop constantly updating something that is recognized as a global brand with the potential prospect of UCITS VI and so on.

“For the first time in 30 years UCITS is becoming stricter as it seeks to adapt to AIFMD to protect retail investors in the same way as professional investors but I don’t think it will impact the brand. I think it will allow it to further develop,” commented Caroline Clemetson, who heads up the Banking and Finance Group at Schellenberg Wittmer in Geneva.

In the opinion of Dominik Rutishauser, Executive Director, GAM (Zurich), a global asset management firm, UCITS has become too flexible with the brand in terms of how one can structure products. In his view, this has gone too far, allowing fund managers to create complex alternative funds in the UCITS format that might not be suitable for retail investors.

“I think the fund industry needs to be careful with this. UCITS V is focused more on the parties involved: the depositary, the Management Company, the asset manager. But I expect UCITS VI will be stricter on the product. Certain investment techniques or instruments will not be allowed that are currently allowed today. After all, we have AIFMD so there is plenty of room to create alternative funds under that regime rather than UCITS,” opined Rutishauser.

Some would argue that UCITS V substantially enhances the brand because of the increased liability on depositaries but not everyone is entirely convinced by this. According to David Painter, Head of Trustee and Depositary Services at SGSS, the balance sheet strength of depositaries is more important. When was the last time a depositary was charged with criminal negligence? asked Painter. He pointed out that the additional costs that come with UCITS V, in part due to the increased liability depositaries face in segregating assets across the custody chain, smaller asset managers might be negatively impacted.

“Large fund managers have the benefits of scale with respect to the compliance and operational costs and are better able to afford it but I worry about the rest of the market. Notwithstanding the additional regulatory burden, one large fund management house I spoke to in the early days of AIFMD and UCITS V adopted a very positive approach to embracing the challenge. They saw it as an opportunity to demonstrate both thought leadership and capability to implement complex regulatory changes, which smaller competitors find difficult to match without additional external support,” recounted Painter.

Broadly speaking, there’s little doubt that with UCITS V, and AIFMD, European regulators have helped to restore investor confidence. Specifically though, some are still unsure that this is the case. In France, for example, Christophe Lepitre, Deputy Managing Director at Paris-based OFI Asset Management, which has EUR65bn in AUM, believes there is still a lack of understanding among investors and that there remains “a lack of confidence in the banks and all things financial. It’s our job, as an industry, to restore that confidence,” said Lepitre.

QUESTION 2 - How do asset managers and asset servicers plan to operate during this period of uncertainty before implementation of UCITS V Level 2 regulation?

Whilst UCITS V is now live, the Level 2 regulations are not due to be implemented until October 2016. These regulations include details on insolvency rules for depositary banks and also the need to demonstrate independence, both with respect to the depositary, the management company, and the asset manager.

Level 3 guidelines as pertain to remuneration provisions under UCITS V are not expected to apply until 1st January 2017. Regulators are yet to agree on how to apply the remuneration provisions. The FCA has published details on how it will apply, but the French and the Germans are not of the same opinion. These are issues that are still being actively discussed, said Clemetson.

Recognising that the six-month gap between Level 1 and Level 2 regulations under UCITS V was far from ideal, the FCA issued a policy statement that will allow for a transition period.

"I think the mindset has been, 'We know the principles of what need to be put in place so let's do that as best we can, taking account of latest guidance and consultation'. Most law firms have been drafting agreements on the basis of best interpretation of Level 1 and will go back and make any final adjustments, if needed, at a later date when Level 2 and updated FCA rules have crystallized the requirements," said Painter.

Rutishauser confirmed that at GAM, "We have already implemented Level 1 guidelines in our fund prospectuses using generic language, as it is currently a common approach in the industry."

The six-month delay might require asset managers to go back to their depositary to renegotiate and sign the depositary agreement, which should not require too much alteration. Of more concern is updating the Operating Memorandum, defining how the asset manager will interact with the depositary.

This is where the issue of independence comes under sharper focus. As such, "it is important to clarify the rules before embarking on a long-term relationship. The same applies for AIFMs when appointing a depositary under AIFMD. Both parties need to be clear on the rules and accept them," explained Anne-Sophie Minaldo, Partner at KPMG (Luxembourg).

With respect to remuneration, Level 2 regulations have essentially been lifted from AIFMD.

AIFMD states that AIFMs shall comply with the remuneration principles "in a way and to the extent appropriate to their size, organisation and the nature, scope and complexity of their activities."

When discussing how the remuneration policy affects private equity managers, Jerome Wittamer, Chairman of the Luxembourg Private Equity & Venture Capital Association ('LPEA') and Founding Partner, Expon Capital, pointed out that the supervisory authorities recognise that what has been written in the AIFMD rulebook does not necessarily make sense to private equity funds.

"For hedge funds it does but with respect to private equity funds, the authorities have shown a willingness to be more relaxed and accommodative towards the application of the remuneration policy. I can't predict the future but if the industry does introduce AIFMD II at some stage then I think there could be some changes in terms of the way that private equity and real estate funds are treated," said Wittamer.

With respect to asset servicers, it is not only the gap between Level 1 and Level 2 regulations that creates a challenge; it is also the fact that different European jurisdictions apply different timeframes to UCITS V. In places like Ireland and Luxembourg it is now live and contracts between depositaries and asset managers have been signed. In France and Germany, they have delayed this by six months, whilst in Italy UCITS V has been running since 22nd July 2015.

For global custodians it is important to be aware of these jurisdictional differences, requiring them to be more prepared in some countries than others.

"Italian asset managers and depositaries have had to comply with the new framework for some time now. They had to sign new agreements and are now operating in compliance with UCITS V. There might be some adjustment regarding the independence issue with respect to Level 2 regulations but it won't significantly impact the independence rules that are already in place," commented Angela Bracci, Senior Adviser, Italian Banking Association, Milan.

QUESTION 3 - Are there any known changes planned for AIFMD II and UCITS VI?

There was some degree of disagreement over the issue of AIFMD II during the European roadshow.

In Zurich, Markus Fuchs, Managing Director of the Swiss Fund and Asset Management Association (SFAMA) was quite adamant in saying: "Harmonisation, in terms of the regulators trying to get all asset management companies to move in the same direction, is very dangerous if that direction ends up being wrong. The system will collapse. I really hope we do not see a private equity version of the AIFMD, a real estate version of the AIFMD and so on. I think it's important for it to remain a single regulatory framework for all alternative funds."

By contrast, in London and Luxembourg there was a feeling that some improvements could be made with respect to how different AIFs – PERE funds, infrastructure funds, investment trusts and so on – are regulated with SGSS's David Painter remarking:

"One of the issues with AIFMD is that it covers a broad range of fund types, which have very different characteristics. Whilst there is very little appetite for even more regulatory change in the near future, I think a more effective approach to overseeing specific fund types and operating models might be achieved by adopting a modular structure focused on each category of AIF, rather than applying blanket regulation to managers."

In some ways, AIFMD is an awkward regulatory framework in the sense that it applies to the hedge fund business but not to the private equity or real estate business. For example, 70% of the data that needs to be reported in Annex IV does not apply to either of these asset classes. In Wittamer's view, it is an ill-conceived piece of regulation. "As it relates to the brand, I think we will have to wait another decade before the AIF becomes something akin to UCITS. The amount raised by private equity in 2015 represented 2% of Europe's EUR19tn GDP. Do these funds really pose a systemic risk? I think you know the answer," said Wittamer.

Clement Labouret, Operations Manager for FIL Gestion (part of Fidelity International), who attended the Paris lunch event hosted by SGSS, shared a similar view by stating that "we would like to see a more suitable directive based on the underlying asset strategy".

He feels that the reporting process for PERE funds should be different; after all, these are investments that are held for multiple years. Reporting on them on a monthly basis seems inappropriate at best.

In London, Bowie confirmed that AIFMs are keen to see changes on the level of reporting under AIFMD. The sheer number of reporting-related questions, some 70-odd, in the ESMA Q&A, show that the reporting rules - covering over 300 data fields - are not easy to interpret, she said, adding: "AIFMD needs time to bed down, rather than thinking about bringing in a second version of the Directive. It's too early for that. Annex IV reporting is one area, however, that we would like to see addressed at this stage."

At this stage there is no indication that AIFMD II is on the cards. It is nothing more than industry gossip. ESMA needs time to get a clearer understanding of how third country passporting rules will play out under AIFMD before it even remotely considers updating the Directive.

"We cannot keep modifying the regulations," said Vincent Dessard, Regulatory Policy Adviser at EFAMA. "The main issues we are looking at are: asset segregation, class actions and obstacles to cross-border distribution, with respect to both UCITS and AIFs. As for UCITS VI, I can confirm that there is no news on this."

On the third country management company passport issue, ESMA should know by 2017 which aspects of this are working well, and which need to be corrected. This will also depend on which countries, aside from Jersey, Guernsey and Switzerland, receive ESMA's approval in 2016. "The third country passporting issue is yet to be resolved. ESMA has decided to take a country-by-country approach. Regulators need more experience understanding how AIFMD works from a manager passport perspective," said Dee Ruddy, Director, Advisory, KPMG (Luxembourg).

QUESTION 4: Will we see convergence of AIF and UCITS regulation? Will this result in a single rulebook?

This was a question that provoked a lot of interesting debate throughout the European roadshow. It is fair to say that there is already a degree of convergence between the two regulatory rulebooks. There are, for example, similar characteristics for the Management Company under UCITS V and AIFMD in terms of capital requirements, internal governance, risk management rules etc., and there are now similar characteristics with remuneration.

Whilst a single rulebook in terms of the responsibilities placed on asset servicers and fund managers would be beneficial to depositaries, one cannot expect to see any sort of convergence between UCITS V and AIFMD with respect to fund-level regulations. In fact, there is likely to be regulatory *divergence* if, in future, AIFMD II does take a more modular approach to how it treats different AIFs (PERE funds versus hedge funds).

"Convergence, when it comes to the Manager and the Depositary is advantageous and is there to some degree already, but uniformity should not be the goal from a product perspective," said Ruddy.

The feeling in both Italy and London was that regulation for alternative fund products and retail products remains "fundamentally different" and that the gap could indeed widen going forward. In Milan, Antonio Napolitano was adamant in saying: "I don't see a single regulatory rulebook happening. But I do foresee more regulation on the product side under AIFMD II."

Indeed, the fact that the rules of conduct are different, the definition of eligible assets is different, leverage and concentration limits and liquidity provisions are different makes it difficult to see how the regulatory rules on UCITS and AIFs could converge.

Anne-Sophie Minaldo was quick to point out that, product regulation aside, the liability regime is much stricter under UCITS V compared to AIFMD.

"A key debate at the moment is that if you accept delegation for the safekeeping of assets outside Europe – requiring the depositary to interact with a third country - how can you be sure that country has the same insolvency laws in place? Who pays for the legal opinion; the fund manager or the depositary sub-delegating the safekeeping of assets?

"The liability regime will remain stricter for UCITS V and therefore I don't agree that there should be a single rulebook," stated Minaldo.

To further clarify, under UCITS V the depositary will be required to update the insolvency rules on any third country sub-custodial agreements it has in place as the depositary will be responsible for the segregation and oversight of assets across the custodial chain. “Our network will have to request these insolvency rules on an ongoing basis and if there are changes, we need to provide them to the asset manager. This places a huge amount of work on the depositary,” said Serge Balatre, Head of Business Development, Depositary Services, SGSS.

Under AIFMD, the appointed depositary to an onshore AIF is required to perform full depositary services but the AIFM is allowed to delegate the safekeeping of assets, and cash management, to their existing Prime Broker(s) and Administrator.

One of the concerns that came out of the audience both in London and Zurich was whether the requirement for full segregation of assets under UCITS V could eventually apply to AIFMD. This is something that AIFMs and prime brokers are pushing against.

“With AIFMD we had to segregate assets in three big blocks as the appointed depositary: all assets, order assets and real assets. For UCITS V we had to segregate in four blocks. We created and sent out new instructions to our custodial counterparts requiring them to segregate assets accordingly. Even with our two Central Securities Depositaries (Euroclear and Clearstream) we are asking them to segregate the assets.

“The issue with segregating assets under AIFMD is that prime brokers say it will be costly. It comes down to their having a different interpretation on segregating the assets. Their interpretation is that they already segregate through books and records from the omnibus account. We are waiting for ESMA to explain what the rule should be,” explained Balatre.

Country-specific insights

Some country-specific questions were discussed during the European roadshow. Below is a selection of key findings:

MILAN- How do you deal with regulatory rulings like depositary liability that impacts the NAV calculation and/or foreign AIFMs managing Italian AIFs without having to comply with same obligations as the local AIFM?

Following on from the above points raised on the additional liability responsibilities on the Depositary under UCITS V, Italy is unique in that it operates a model called *Affidamento*.

This allows the Management Company to appoint the depositary to directly calculate the fund’s NAV. The depositary defines the valuation criteria and agrees on them with the ManCo. “In 2014, when AIFMD was transposed into Italian law, legislators removed *Affidamento* for Italian hedge funds but it remained for UCITS. We do not know if it will remain under UCITS V. It is good for the depositary because it is strictly linked with the ManCo and is directly responsible for carrying out the valuations; it strengthens the relationship between the two parties,” said Angela Bracci.

As such, Italian depositaries have more responsibility for UCITS funds than other EU Member States. For Italian AIFMs, *Affidamento* improves efficiency in the operation of UCITS funds but this option is not available to foreign AIFMs running Italian UCITS funds. In Germany, by contrast, managers have the option of being jointly responsible for the production of the fund’s NAV with the depositary. The question is, when the independence provisions between the depositary and the asset manager come into effect in October, will *Affidamento* continue? Will the German model continue?

“Could the depositary provide an external valuation role under UCITS V? No one yet knows,” said Napolitano.

LONDON: What will be the impact of BREXIT on the UK funds industry?

The London panel said that a lot of UK asset managers are sitting on the fence. At this stage there are still so many 'What ifs…' that it is hard to know what the negotiation would be in the event of Brexit but Karen Bowie's opinion, "If there were a Brexit it would be profoundly disruptive to the asset management industry".

One fear is that Brexit could make it harder for UK managers to sell UK-domiciled UCITS funds in Europe because of tariffs. If that were the case, UK managers might potentially start considering whether or not to re-domicile their funds in EU fund centres such as Ireland and Luxembourg. David Painter had a slightly different view on this, however:

"It's more an issue of where the *manager* is located rather than where the fund is located," said Painter. "If you've got a fund in Luxembourg it's probably managed in a similar way to one managed in the UK or Ireland. Brexit might, therefore, impact where the manager resides in terms of running the fund. Will they choose to remain in the UK? That might change."

ZURICH: How do you deal with the MANCO passport and/or UCITS/AIFs distribution from/to Switzerland?

The ManCo passport is not a priority in Switzerland, according to SFAMA's Markus Fuchs. What is of more importance, he said, is the fund passport for marketing and distribution. "We are doing everything possible through discussions with ESMA to allow Swiss-based managers to passport funds, irrespective of whether these are domiciled in Switzerland or offshore, into Europe," commented Fuchs.

AIFMD is the first regulation to allow a fund passport for third countries like Switzerland. The fact that the Swiss authorities introduced a revised version of the Collective Investment Schemes Act ('CISA') in 2012 to bring it into line with AIFMD was important, given that ESMA approved Switzerland for the third country passport at the end of 2015.

For those Swiss managers who already have a presence in Europe it's less important but the passport is a huge advantage for small and mid-sized Swiss managers to market their funds – be they Swiss funds, Lux funds, Cayman funds – into Europe. "It is important that Switzerland fights to get this passport formerly introduced. After all, EU managers have full access to Swiss investors," said Clemetson.

With respect to the ManCo passport, GAM's Rutishauser confirmed the group operates two Management Companies in Luxembourg and Ireland, the former being a 'Super ManCo' to support GAM's range of UCITS funds and AIFs. He said that whilst it could feasibly be possible to converge the two ManCos into a single hub, to run alongside its Swiss Management Company, there remains a degree of skepticism as to whether the passport would be truly beneficial.

"The biggest financial players are operating out of one ManCo in Europe and passporting the ManCo license to different fund hubs. On paper it looks nice to do this but there are practical issues that could arise; if there is an issue in Luxembourg and the ManCo is based in London, who is responsible? How would it would on the tax side?

"For the time being we are happy to operate from different hubs in Europe," concluded Rutishauser.