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REGULATORY RELATIONS

The rationale for an EU fund depositary passport

Christopher P. Buttigieg | November 18, 2021

The creation of the internal market in the field of financial services was primarily established on the principle of mutual recognition between member states, which is contingent on different levels of harmonisation and supervisory convergence. Authorised financial services operators are granted a passport to provide products and services across the EU based on a notification to the host regulator but without requiring additional authorisations in the host member state. By Dr Christopher P. Buttigieg, PhD, chief officer supervision, Malta Financial Services Authority.

In the area of investment funds, such a passport has been granted to the asset manager and for the marketing of investment funds in terms of the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings for Collective Investment in Transferable Securities Directive (UCITSD). The AIFMD and the UCITSD do not provide for a depositary passport. The AIFMD is currently being reviewed, giving an opportunity for this issue to get back onto the agenda.

Depositaries are the most important service providers of an AIF from an investor protection perspective because they also safeguard the assets of the fund. Presently, the depositary must be registered or established in the same member state as the investment fund, which restricts the choice of depositaries available and limits competition (possibly also raising costs).

The European Commission has on a number of occasions over the years proposed and consulted stakeholders regarding the introduction of a depositary passport. As far back as 1993, it proposed a depositary passport under the UCITSD. However, during the negotiations it was claimed that a depositary passport would create a number of legal issues, including around the prevailing legal system which should apply in case of default and possibly lower levels of co-ordination and co-operation between the management company and the depositary, which would have negative implications on investor protection.

Since the 1993 proposal, the commission has carried out several consultations and studies on the introduction of the depositary passport, outlining the advantages and the changes required to implement an internal market in this field, harmonisation of regulation and a certain degree of supervisory convergence and co-ordination being key pillars for the depositary passport to work.

After the 2008-2009 financial crisis, largely triggered by the consequences of the Madoff fraud and the failure of Lehman Brothers on investment funds, amendments to the AIFMD and the UCITSD imposed a more harmonised and onerous framework for depositaries, including detailed eligibility criteria and rules on liability, delegation and the oversight function. The updated framework imposed extensive governance, prudential, conduct and transparency requirements on depositaries and relates, in particular, to the safekeeping of clients' assets.

In the context of the EU, harmonisation is not carried out for its own sake but to fulfill the freedom to provide services (as set out in Article 56 of the Treaty of the Functioning of the European Union) by allowing mutual recognition between member states and, as a result, open access to the internal market. Therefore, at this stage, one might argue that the obligation for the depositary to be established in the same member state of the investment fund is a barrier to cross-border business that cannot be justified on the basis of insufficient regulatory harmonisation but may be partly resulting from the lack of mutual trust between member states with regard to the supervision of depositaries.

This notwithstanding, some member states retain wide-ranging concerns with regard to the supervision of depositary passport arrangements, even though the industry – with some exceptions – expressed positive remarks about the possible implementation of a depositary passport.

ECB supervised firms

Extending the depositary passport only to credit institutions and investment firms supervised by the European Central Bank (ECB) could also help to solve the supervisory conundrum. This should be acceptable to large EU member states and is easily implementable. After all, the ECB already covers the depositary business under the Supervisory Review and Evaluation Process, and broadening the scope and incorporating depositary business into the Single Supervisory Mechanism (SSM) would not be a significant change. It is worth pointing out that out of 40 main depositaries operating in Germany, only three are not licensed as credit institutions.

The only weakness of this proposal is that it would leave out those operators that fall outside the SSM framework. In this regard, if a centralised approach is not the preferred option and given the limitations of the ECB SSM to credit institutions and certain investment firms in the euro area, an option that could be considered is the setting up of colleges of supervisors co-ordinated by the European Securities and Markets Authority. This solution would leave supervision at the level of the home member state, while recognising the need for other member states to take a role in the supervisory process. A properly co-ordinated and strong college of supervisors would create a forum for discussion, mutual co-operation and learning, which would in turn contribute to the overall process of convergence.

One could argue that centralised supervision at European level would be a more suitable basis for the depositary passport, because shared supervision may be highly inefficient and may not be adequate to ensure stability. However, given the investor protection concerns that could arise from the losses suffered in case of failure of a depositary, national financial supervisors would want to retain supervisory control over depositary business.

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