Depositary
And
Trustee
Association

11 May 2020

Personal Finances and Funds
1 Blue, HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

By email to: overseasfundsregime@hmtreasury.gov.uk

Dear Sirs,

Overseas Funds Regime : Consultation

The Depositary and Trustee Association ("DATA") represents depositaries and trustees of UK based investment funds, including Open Ended Investment Companies (OEICs, also referred to as Investment Companies with Variable Capital), Unit Trusts and Authorised Contractual Schemes (ACS).

DATA's response does not address the detail on how overseas funds should be able to access the UK retail market. Rather it specifically addresses a couple of questions which DATA believes have implications for the competitiveness of UK authorised funds.

While DATA is in principle supportive of overseas funds being able to access the UK retail market, it is important that there is equitable treatment between overseas funds being sold into the UK and domestic UK authorised funds, and in particular that the latter are not competitively disadvantaged. DATA therefore recommends the following principles should apply to the OFR:

- The assessment of regulatory equivalence on an outcomes basis should be holistic, including an assessment of guidance and interpretation of applicable regulations applied by the overseas regulator as compared to the UK;
- The OFR should ensure equivalent standards apply to overseas funds sold into the UK and UK authorised funds, and in particular that UK funds are not put at a competitive disadvantage by allowing the sale of overseas funds to retail investors that do not need to meet requirements applicable to UK domiciled funds;
- A fund should not be permitted to be sold to the UK retail market under the OFR if it had features, characteristics or investment and borrowing powers that would not be permitted in the UK;
- Where the FCA deems any requirement imposed on a UK fund is not required to be complied with by overseas funds to meet the outcomes-based equivalence tests, the FCA must be

required to review and consult within a reasonable timeframe whether the UK requirement should be disapplied;

- The FCA should be able to step in, on an individual product level where required, where interpretation of regulations and practices differ in a material way from those applied to UK authorised funds; and
- Mutual and reciprocal recognition should be sought for UK authorised funds, in particular UK UCITS, from the overseas jurisdiction being assessed for equivalence.

Consideration should also be given to the look-though requirements in relation to FSCS levy obligations and which have been in force since 2018 for managers and depositaries of UK authorised funds, in light of statements made in the consultation.

Please do not hesitate to contact me if you would like to discuss any of the points we have raised.

Yours faithfully

Craig Bowie
DATA Chairman

Annex 1: DATA Response to Overseas Fund Regime (OFR) Consultation

Q1. Are there any other relevant factors HM Treasury should consider in the design of the equivalence regime for retail funds?

DATA is supportive of a fair and accessible regime to enable overseas funds to be sold into the UK retail market, but the regime must be designed in a way that ensures fair treatment for UK authorised funds, and the managers and depositaries of these funds. While there is merit in considering regulatory equivalence on an outcomes basis, noting that precise rules, frameworks and conventions will inevitably vary between jurisdictions, if such an assessment is insufficiently holistic it could result in UK funds being competitively disadvantaged.

The proposed regime appears to require an assessment that demonstrates there is equivalent regulation, not equivalent interpretation of that regulation. It is often in the application of guidance and interpretation where additional requirements are effectively applied. It is therefore important when performing an equivalence assessment that not only are the rules in the jurisdiction in question considered, but also the guidance and interpretation applied to those rules compared to those applied in the UK.

It has for some time been the experience of DATA members that the expectations of the FCA on the role of the depositary greatly exceed the expectations of other European national regulators towards depositaries of UCITS. Examples include the following:

<u>Liquidity monitoring and stress testing</u>: the rules introduced by the FCA in PS19/24 will require depositaries of funds deemed to be funds investing in inherently illiquid assets (FIIA) to perform enhanced monitoring of the liquidity risks and liquidity profile of the FIIA. In addition, the FCA has yet to confirm that it does not expect depositaries to perform their own liquidity calculations and stress tests, despite depositaries lacking the information required to carry out any form of meaningful assessment. This requirement greatly exceeds, and indeed conflicts, with the principled view taken in ESMA Guidelines on Liquidity Stress Testing for UCITS, established after an extensive and informed consultation process, which specifies that depositaries are only required to verify that the manager has procedures in place to perform liquidity stress testing, and explicitly states that the depositary is not required to reperform liquidity stress tests.

<u>Requirement to register other assets in the name of the depositary</u>: COLL 6.6.12R requires the depositary to ensure all scheme property of UK authorised funds to be registered in the name of the depositary, regardless of whether the asset is a financial instrument. In contrast, both the UCITS Directive and AIFMD require only that certain financial instruments are registered in the name of the depositary; these permit non-financial instruments or "other assets" to be registered in the name of the fund, the manager on behalf of the fund or the depositary. Other EU jurisdictions apply the approach set out in the directives in respect of the registration of other assets. Requiring the depositary to hold title to non-standard investments exposes the depositary to risks that are outside its fiduciary and regulatory duties. These complications were not envisaged by those who drafted the COLL rules which cater for a different era. For example, the current COLL rule exposes the depositary of a real estate fund to the potential risk of environmental claims. If the UK rules were corrected to align with the EU directive position, the depositary would no longer face this complex risk, but would still need to meet strong investor protection rules designed to ensure the scheme had good title to the asset (e.g. by ensuring appropriate title was and continued to be reflected at the Land Registry).

<u>Independence of the depositary</u>: the FCA requires that UK depositaries are structurally independent of the manager. While the requirement for UK depositaries does not entirely prohibit any cross

ownership between the depositary and the manager, in practice the interpretation and application of these requirements means that a depositary cannot be in the same corporate group as the manager. This is not the case in most EU member states, where a depositary is only required to be functionally independent of the manager, which means provided the majority of the supervisory board of the depositary does not consist of the same members as that of the manager, both the depositary and manager can be in the same corporate group.

Financial Services Compensation Scheme (FSCS): Depositaries are required to pay into the FSCS, despite there never having been any claims made against the scheme for losses due to the failure of a depositary, and the extremely low likelihood of such a scenario arising. The EU Investor Compensation Scheme Directive allows for the exemption of managers and depositaries of UCITS, an exemption applied in all the other main EU fund domiciles. Our response to Q19 explores the FSCS in more detail.

Our response focuses on those examples pertinent to depositaries, but we note that similar examples apply in respect of managers of UK authorised funds, which do not apply to UCITS managers in other EU jurisdictions, such as the requirement to perform an annual assessment of value, requirements on fund names, fund objectives and benchmark disclosures, and the extension of the scope of the FSCS.

In view of how rules and guidance have been applied, there is a risk that the UK authorised funds industry could be left at a significant competitive disadvantage if an assessment performed on an outcomes basis considers only the rules that applies in each regime. For example, while the rules applying to depositary oversight of liquidity may not appear substantially different, the expectations of how depositaries comply with these rules is very different in the UK compared with other EU jurisdictions. Given that liquidity management cuts across portfolio management decisions, managers may decide to relocate their funds in other EU jurisdictions rather than have to deal with perceived depositary "meddling" in this important area impacting investment decisions if they are able to sell these funds easily into the UK without those requirements applying.

Such relocations to avoid UK gold-plating would be detrimental to the growth of the UK funds industry, the jobs and tax revenue this provides, and ultimately the position of the UK as an international financial centre. In this respect, it is important that regulation of UK authorised funds is aligned to international standards, ensuring that while investor protection standards are maintained the UK funds industry remains competitive.

It is not necessarily the case that additional requirements should be applied in all cases to match UK requirements. If an assessment indicates that a jurisdiction is delivering equivalent regulatory outcomes without having a requirement that applies in the UK, this effectively suggests that the UK requirement is likely to be a redundant and unnecessary regulatory burden on UK firms. This should therefore trigger a review of the UK requirements.

Finally, the consultation does not make any reference to reciprocal arrangements. Access into UK markets should not be one way. Although recognising that this may not always be achieved, DATA believes that the framework for the OFR should have an objective of seeking mutual recognition for UK authorised funds in the jurisdiction being assessed. Again, failure to do so risks relocation of UK-domiciled funds, with the consequent adverse impact on the UK funds industry, jobs and tax revenues referred to earlier.

In summary, DATA believes the following principles should be incorporated into the framework OFR:

- The assessment of regulatory equivalence on an outcomes basis should be holistic, including an assessment of guidance and interpretation of applicable regulations applied by the overseas regulator as compared to the UK;
- The OFR should ensure equivalent standards apply to overseas funds sold into the UK and UK authorised funds, and in particular that UK funds are not put at a competitive disadvantage by allowing the sale of overseas funds to retail investors that do not need to meet requirements applicable to UK domiciled funds;
- A fund should not be permitted to be sold to the UK retail market under the OFR if it had features, characteristics or investment and borrowing powers that would not be permitted in the UK;
- Where the FCA deems any requirement imposed on a UK fund is not required to be complied with by overseas funds to meet the outcomes-based equivalence tests, the FCA must be required to review and consult within a reasonable timeframe whether the UK requirement should be disapplied;
- The FCA should be able to step in, on an individual product level where required, where interpretation of regulations and practices differ in a material way from those applied to UK authorised funds; and
- Mutual and reciprocal recognition should be sought for UK authorised funds, in particular UK UCITS, from the overseas jurisdiction being assessed for equivalence.

Q19. In your view is it necessary to extend the scope of FSCS to apply to funds recognised under the OFR? What are the advantages and disadvantages of this approach?

DATA notes, with some surprise, the statement in the consultation in paragraph 5.20, that "*the government has not seen evidence of any losses suffered by UK investors that would have been compensated if funds passporting into the UK had been required to be members of the FSCS. This may be attributed to the strict rules that apply to UCITS, including the arrangements for independent depositories and the safeguarding of assets.*"

DATA fully agrees with this statement, yet this statement is equally true of UK authorised funds, especially UK UCITS. DATA is not aware of a single case of a failure of a UK authorised fund, a UK authorised fund manager or a UK depositary that resulted in claims against the FSCS. This is not coincidental – there are examples of UK authorised funds and UK authorised fund managers failing, but the strict asset segregation requirements, investment power rules and depositary oversight requirements provide structural protections that prevented losses arising to investors that resulted in claims against the FSCS. (It should be noted that these protections do not prevent market losses, but these are an inherent risk of the investment exposure provided by the product, are clearly disclosed to investors and are not covered by the FSCS.)

There is therefore no evidence that including UK authorised funds or overseas retail funds in the FSCS provides any meaningful investor protection in addition to the structural protections of UK authorised funds, UCITS and other equivalent fund structures.

While DATA believes it should not be necessary to extend the coverage of the FSCS to depositaries of overseas funds, the same is equally true of depositaries of UK authorised funds. Requiring depositaries of UK authorised funds, under the look through requirements introduced in 2018, to pay into the FSCS, and moreover to contribute towards 25% of the intermediary class levy (for which UK depositaries have no affiliation), while allowing depositaries of overseas funds sold into the UK retail market to remain exempt from FSCS, is inequitable. This would put depositaries of UK authorised funds at a financial and competitive disadvantage against depositaries of overseas funds.

DATA’s preferred solution is that the look-through rules that bring UK depositaries into the scope of the FSCS should be disapplied. However, if the government and FCA believe it is necessary for depositaries of UK authorised funds to remain within the scope of the FSCS, the scope of the FSCS should be equally extended to cover UK eligible claimants in overseas funds recognised under the OFR.