THE CITY OF LONDON LAW SOCIETY

4 College Hill
London EC4R 2RB
Tel: 020 7329 2173
Fax: 020 7329 2190
www.citysolicitors.org.uk

BY E-MAIL

EU Commission
DG MARKT Unit G.4
markt-depositary-consultation@ec.europa.eu

15 September 2009

Dear Sirs

WORKING DOCUMENT OF THE COMMISSION SERVICES (DG MARKT CONSULTATION ON THE UCITS DEPOSITARY FUNCTION)

The City of London Law Society ("**CLLS**") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Regulatory Committee (the "**Committee**"). Members of the Committee advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

We are responding to the Commission's consultation paper because of its important implications for the structure of both the UCITS and the alternative investment fund market. We are not commenting on policy choices, but on the importance of ensuring that there is a sound framework which provides legal certainty both to the depositary and the manager as well as investors. We are therefore addressing the following questions in our response.

Q1.	Do you agree that the safe-keeping and administration duties of depositaries should be clarified?
Q13.	Do you agree that there should be a general clarification of the liability regime applicable to the UCITS depositary in cases of improper performance of custody duties?

Q14.	What adjustments to the liability regime associated to the custody duties of the UCITS depositary would be appropriate and under what conditions?
Q25.	Do you agree that only institutions subject to the CDR should be eligible to act as UCITS depositaries?
Q26.	If not, which types of institutions should be eligible to act as UCITS depositaries, and why?

We do agree that safe-keeping and administration duties of depositaries should be clarified, as should the applicable liability regime. However, we do not think that such a clarification can occur in a vacuum and there must first of all be an assessment of the duties that it is appropriate to impose on a depositary, taking into account the context in which the depositary may operate. All of this should be done against the background of a proper cost-benefit analysis which should enable the economic effect of different policy judgments to be understood. In order for the Commission to establish whether any proposed liability regime is proportionate, workable, and beneficial to consumers, an assessment needs to be made of the additional costs depositaries, and investors (who would ultimately bear the costs of additional depositary liability), would have to bear as a result of the proposed liability regime. As currently proposed, there is insufficient certainty as to what the depositary's duties would be in order to allow this assessment.

We do not think that a liability regime can be developed until there is greater clarity of the duties that are expected and of the regulatory standards that apply to such duties. We note that there is much discussion in relation to the concept of "strict liability", but we do not believe that adequate consideration has been given from a legal perspective as to what this concept is to cover. If by "strict liability" it is intended that the depositary should provide financial compensation in the event of the fund suffering any loss (other than a loss related to pure investment risk) then this is more akin to insurance, rather than a strict liability for breach of a defined duty. We do not believe that such a wide approach to strict liability would prove to be either practicable or necessary.

We therefore consider that the Commission must first analyse the duties that should be applied to depositaries and the standards to which these duties should be performed and examine the range of risks that can arise in connection with fund property, before deciding on an appropriate liability regime. The scope of the diligence responsibilities of the depositary are unclear in the proposal, and need more detail to enable market participants to price their impact.

We do not agree, for example, that market risk associated with their investment is the only acceptable risk that an investor should have to bear. If this statement is the Commission's view, then this will require a depositary to act as an "insurer" against, for example, the possibility of failure on the part of an international central securities depositary, or indeed merely against the operation of such an entity's "shortfall" rule. It is common, in depositaries around the world, for there to be a provision which provides for any shortfall, which cannot be attributed in any other way, to be shared between all the relevant participants in the depositary. The fact that such a provision may rarely (if ever) be invoked will not be relevant - if the depositary is expected to "insure" against it then this will require it to have a liability, where there is no real corresponding duty which it could fulfil.

Similar concerns arise in relation to subcustodians. Subcustodians are commonly used by depositaries, as no depositary will have access to central securities settlement systems in each jurisdiction worldwide. A strict liability rule for subcustodians would require a depositary to underwrite the solvency of each subcustodian it uses. This would have the effect of

concentrating credit risk in the hands of depositaries, as on a failure of a subcustodian, whether or not the depositary should have been aware of its impending failure (and often it will not), it will be required to guarantee the return of the subcustodied assets. This poses the problem of adding systemic risk to the banking system, as the failure of a subcustodian would adversely impact the solvency of any depositary using it. That risk, and the costs associated with it, needs to be factored into the impact assessment performed in relation to the proposal.

A further potential cost arises from the risk of limited access of UCITS funds to markets considered too risky for depositaries to invest in. Where a depositary has primary liability for the failure of a subcustodian or depositary in a small emerging market, it may be the case that access into that market may simply cease.

Credit institutions currently do not carry capital against the risk of securities depositaries or subcustodians failing, on grounds that they do not have credit risk on them. It will be clear that if they are required to guarantee or insure those entities, then they will bear credit risk on them which would require appropriate capital to be held against the risk of their failing. Given the amount of securities held by depositaries, it may be expected that there would be a significant additional capital requirement associated with the proposed regime. This should be factored into any cost-benefit analysis.

We do not agree that only credit institutions should be eligible to be depositaries, either in the UCITS or in the AIFM context. The Commission suggests that a key reason for UCITS requiring the appointment of a credit institution lies in the fact that the firm is subject to the CRD. However as the Commission notes, investment firms are also subject to the CRD, so we cannot see that this is a reason to distinguish banks from other firms. Particularly when viewed in the context of alternative investment funds, and certainly those funds where the underlying assets are illiquid, there would appear to be no good reason for the depositary to be either a credit institution or an investment firm - taking into account the nature of the underlying assets and the nature of the investment in the fund. When considering the nature and identity of the depositary, regard must be had to the context in which the depositary operates and its resources (which may include insurance) that are available to meet any liabilities that it is considered that it should have.

A further question which should be addressed is how the legislation would in practice result in consistent standards of liability across Member States. The implementation of the UCITS Directive amply demonstrates that the same provisions as to liability can be interpreted differently by the courts of different Member States. The same risk will arise in relation to any formulation that a new directive may use to establish liability: it seems likely that interpretations of what constitutes "wrong performance" of the obligations of the depositary will differ, creating uncertainty, and potentially an unlevel playing field, across Europe.

We would be delighted to discuss the above concerns with you. You may contact me on +44 207 295 3233 or by e-mail at margaret.chamberlain@traverssmith.com.

Yours faithfully

p.p. J. Tony

Margaret Chamberlain
Chair CLLS Regulatory Committee

Members of the CLLS:

Bridget Barker, Macfarlanes
Chris Bates, Clifford Chance
David Berman, Macfarlanes
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