1 Introduction

In July 2012, the European Commission (the “Commission”) published a draft directive which seeks to amend the regulatory framework for Undertakings for Collective Investment in Transferable Securities (“UCITS”). Two main factors can be identified in terms of the stimulus behind this draft legislation. First, the Madoff fraud and the Lehman Brothers default which revealed material divergences in rules on depositary duties and liabilities across EU member states and second, the desire to align the UCITS framework with the new depositary rules, rules on remuneration and sanctions procedures under the Alternative Investment Fund Managers Directive (“AIFMD”), which is itself a product of the financial crisis. The principal aim of the reform is to create uniform market conditions across the EU, thereby increasing investor protection and investor confidence and safeguarding the integrity of the UCITS market and brand worldwide. The Commission has proposed a number of amendments to the UCITS regime with a view to achieving these objectives, referred to collectively as “UCITS V”.

The Commission’s proposals have been considered and voted upon by the European Parliament, which has made a number of significant amendments to the Commission’s text, and the Council of the EU has agreed its general approach. The draft directive is now the subject of trilogue negotiations between the Council, European Parliament and the Commission and it is anticipated that agreement on a final text will be reached in 2014, with the provisions to become applicable two years later in 2016.

UCITS V focuses on three main areas:

(a) a new depositary regime which includes a clarification of depositary eligibility, duties, responsibilities and liabilities and a set of rules under which tasks and responsibilities can be delegated – mainly focusing on the sub-custodian network;
(b) rules governing remuneration policies of UCITS managers consistent with those under AIFMD and the Capital Requirements Directive and that must be applied to key members of the UCITS managerial staff; and
(c) the harmonisation of the minimum administrative sanctions regime across member states. This follows on from an earlier Commission study which revealed wide divergence across EU member states in relation to the criteria and sanctions applicable for breaches of UCITS rules.

In this memo, we have highlighted the key elements of change which are anticipated by UCITS V and the implications the introduction of UCITS V may have for UCITS, UCITS management companies and depositaries.

2 Depository Eligibility

Under current UCITS rules, member states enjoy a discretion as to the institutions deemed eligible to act as UCITS depositaries, provided that the depositaries are institutions which are subject to prudential regulation and ongoing supervision. The Commission proposal requires a UCITS depositary to be either (i) a credit institution or (ii) a MiFID investment firm. Under the draft legislation, existing depositaries of UCITS who do not fall into these categories will have an opportunity to convert into eligible entities. The Commission noted in this regard that each of these categories of depositaries will provide sufficient guarantees in terms of prudential regulation, capital requirements and effective supervision. The proposal also clarifies that a single depositary must be appointed and, in line with AIFMD, such appointment requires a written contract.

The Commission is of the view that most UCITS depositaries are already credit institutions or regulated investment firms and, therefore, the impact of the eligibility requirement would only concern a small minority of unlicensed service providers. In Ireland, however, only a small minority of entities authorised by the Central Bank to provide depositary services to UCITS fall within the narrow categories of credit institutions or MiFID authorised entities as proposed by the Commission in the UCITS V proposals.

The European Parliament voted on its amended text in July 2013, which provides for a third category of eligible depositary to include “any other category of institution that is subject to prudential regulation and ongoing supervision provided it is subject to capital requirements as well as prudential and organisational requirements of the same effect” as credit institutions or investment firms. The Council has also proposed a similar category of eligible depositary.

3 Duties of the depositary

UCITS V includes a uniform list of oversight duties and safe-keeping obligations of depositaries in order to ensure maximum harmonisation between member states. With regard to safekeeping duties, UCITS V now distinguishes between financial instruments that can be held in custody by the depositary and record keeping and ownership verification requirements relating to assets that are not physically held (ie, financial instruments that may only be followed through a position-keeping book).

A uniform list of oversight duties incumbent on contractual UCITS and corporate UCITS is also prescribed within the draft legal text. These include (i) verifying that units are sold, issued, repurchased, redeemed and cancelled in compliance with applicable rules; (ii) ensuring that the value of units is calculated in accordance with applicable rules; (iii) carrying out instructions of the management or investment company unless they conflict with applicable rules; (iv) verifying that considerations are remitted within the usual time limits; and (v) verifying that UCITS income is applied in accordance with applicable rules.

In addition to its current oversight functions, the depositary under UCITS V will have an additional cash monitoring role. Similar to the provisions of the AIFMD, the depositary will need to ensure that the cash flows are properly monitored and in particular that all payments made by or on behalf of the investors, upon the subscription of units of the UCITS, have been received, and that all cash of the UCITS has been booked in cash accounts.
that are opened in the name of the UCITS. The Commission’s intention is to increase investor protection by reducing the possibility of fraudulent cash transfers. The proposals also include a requirement relating to the segregation of UCITS’ assets from the assets of the depositary, so that any financial instruments on the depositary’s book held for a UCITS can be distinguished from the depositary’s own assets and can at all times be identified as belonging to that UCITS. The Central Bank of Ireland already applies this requirement to Irish depositaries.

In performing its tasks, a depositary is obliged to act honestly, fairly, professionally, independently and in the interest of the UCITS or of the investors of the UCITS.

4 Delegation of depositary safekeeping duties

Given that UCITS may now invest in an increasingly complex array of financial instruments and in many markets outside of the EU, fund managers often require depositaries to appoint sub-custodians in third market countries. However, the use of local sub-custody networks can pose considerable risks to a UCITS. The Commission is proposing to align the requirements regarding delegation of custody with those set out in AIFMD. A UCITS depositary would therefore only be permitted to delegate in respect of safekeeping duties where certain conditions are satisfied, including:

- there must be an objective reason for the delegation and there must be no intention to circumvent the directive;
- the depositary must exercise all due skill, care and diligence in the selection and the appointment of any third party; and
- there must be periodic review and ongoing monitoring of the third party.

In addition, the depositary must ensure that the sub-custodian meets a range of specific conditions, while it continues to carry out safekeeping functions on the depositary’s behalf. These are new conditions that were not previously contained in the UCITS IV directive and replicate certain provisions of the AIFMD. Where the function delegated is the safekeeping of financial instruments which may be held in custody, the delegate must be subject to effective prudential regulation including minimum capital requirements and supervision in the jurisdiction concerned and the custody tasks must be subject to an external periodic audit to ensure that the financial instruments are in its possession. The sub-custodian must segregate the assets of the depositary’s clients from its own assets, and from the assets of the depositary, so that they can be clearly identified as belonging to the clients of the depositary. Further, the sub-custodian may not make use of the assets without the prior consent of the UCITS (or management company) and prior notification of the depositary. These conditions will require depositaries to amend their sub-custodian agreements to ensure that all of the requirements imposed on delegates under UCITS V are set out in the agreements between them.

It should be noted that where local law requires that certain financial instruments be held in custody by a local entity and no local entities satisfy the delegation requirements, the depositary may nonetheless appoint a local entity provided certain disclosure requirements are satisfied and the UCITS or its management company has expressly instructed the depositary to delegate to such a local entity.

One proposal which is of particular concern is the requirement that the prospectus of a UCITS must contain a description of any safekeeping functions delegated by the depositary, identification of the delegate and any conflicts of interest that arise from such delegation. This provision corresponds with a similar investor disclosure requirement contained in the AIFMD with the important distinction that the AIFMD only stipulates that this information must be provided to investors, not that it must be contained in the prospectus. A requirement for such information to be disclosed in the prospectus would introduce significant operational and practical challenges, as well as increasing costs borne by the end investor. The text voted upon by the European Parliament provides that information on all entities involved in providing custody of the fund’s assets, together with conflicts of interest that may arise, should be made available on request from the depositary.
5 Depository liability

Under the existing UCITS regime, the current standard of care for the depositary is that a depositary is liable for: (i) unjustifiable failure to perform its obligations; or (ii) its improper performance of them. The Commission states that the terminology used has given rise to very different interpretations across EU member states, which has resulted in UCITS investors being provided with different levels of protections depending on the domicile of the UCITS in which they have invested. The Commission aims to harmonise depositary liability under UCITS V by introducing the requirements set out below.

- A UCITS depositary is obliged to return a financial instrument of the identical type or corresponding amount to the UCITS, without undue delay, if it is deemed liable for the loss.
- The depositary will only be able to discharge liability where it can prove that the loss of assets is due to an “external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary”.
- The depositary’s liability will not be affected by the fact that it has entrusted to a third party all or some of its custody tasks and therefore the depositary will be liable for the loss of assets even where the loss occurred at the level of the sub-custodian.
- Apart from the case of the loss of a financial asset, the depositary will also be liable to the UCITS and the investors of a UCITS if a loss is suffered as a result of the depositary’s negligence or intentional failure to properly fulfil its obligations under the UCITS Directive.
- It should be noted that UCITS V distinguishes between assets that are capable of being held in custody and those that are not. Therefore, a depositary will not be liable to return assets not capable of being held in custody, such as OTC derivatives, where the depositary has an obligation to verify ownership and keep a record of such instruments.
- While the liability provisions largely reflect the liability provisions applicable to depositaries under the AIFMD, one notable distinction between the two liability regimes is that depositaries of UCITS will not be permitted to exclude or limit their liability under contract. The Commission has noted that given the large investor base and retail nature of UCITS investors, it would not be “entirely appropriate” to permit a contractual carve-out limiting the liability of the UCITS depositary.
- The depositary bears the burden of proof in demonstrating that it has duly performed its duties.

The Commission also proposes to give new rights to all UCITS investors so that they may invoke the liability of the depositary directly or indirectly through the management company, irrespective of the legal structure of the fund. The wording in the draft legislation differs to that set out in the AIFMD which states that the right to invoke claims should depend on the legal nature of the relationship between the depositary, the management company and the investors.

6 Remuneration provisions

The financial crisis engendered an increased focus on remuneration across the financial sector. The Commission is of the view that the remuneration and incentive schemes for fund managers have led to short-term decision making and encouraged excessive risk taking. In its view, remuneration of UCITS managers based on performance provides an incentive for those managing UCITS to increase risk in order to increase potential returns. Therefore, the Commission has sought to introduce sound remuneration principles in UCITS V.

Consistent with the approach adopted in the AIFMD, the UCITS V proposals require UCITS managers to implement remuneration policies and practices (covering salaries and discretionary pension benefits) that are consistent with and promote sound and effective risk management of the UCITS fund, that discourage disproportionate risk-taking which is inconsistent with the risk profiles or fund rules governing the relevant UCITS and

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that are in line with the business strategy, objectives, values and interests of the management company and the UCITS it manages or the investors. The policies and practices should also include measures to avoid conflicts of interest.

The remuneration proposals shall apply to any staff members whose professional activities “have a material impact on the risk profiles of the UCITS they manage”, and include senior management, those in supervisory functions, risk management functions and other employees in the same pay bracket as senior management and whose activities can materially impact the risk profile of the UCITS under management. The European Parliament’s text broadens the categories of staff to which the remuneration requirements will apply further. The Parliament text provides that the remuneration requirements apply to persons who have the power to exercise influence on staff, including investment policy advisers and analysts and persons who take investment decisions that affect the risk position of the fund. It also clarifies that the specified categories include temporary and contract staff.

The principle of proportionality applies here and management companies are to comply in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities. Following the introduction of UCITS V, remuneration policies should address the following key elements:

- criteria for calculating compensation for different categories of staff;
- rules for guaranteed variable remuneration;
- rules for fixed and variable components of total remuneration;
- rules on pension benefits; and
- rules for payments related to termination of employment.

The management body of the management company must adopt and periodically review the general principles of the remuneration policy and is responsible for its implementation. There must be at least annual central and independent internal review of compliance with remuneration policies and procedures. Furthermore, UCITS V introduces a requirement that the total remuneration paid by the management company and by the UCITS, to its staff, be disclosed in the annual report of the UCITS, together with the number of beneficiaries and, where relevant, carried interest paid by the UCITS. The remuneration policy adopted must be audited at least annually in order to ensure compliance with the policies and procedures adopted by senior management.

Management companies that are significant in terms of their size or the size of the UCITS they manage, their internal organisation and the nature, scope and complexity of their activities are required to establish a remuneration committee. This committee is required to directly oversee the remuneration of the senior officers in the risk management and compliance functions.

The new remuneration rules will require management companies to begin to assess which members of staff and which employment contracts may be impacted. Management companies should also start thinking about a comprehensive approach for setting up a compliant remuneration structure so as to be able to implicate all the relevant stakeholders in time.

It is expected that the European Securities and Markets Authority (“ESMA”) will issue guidelines on sound remuneration policies, similar to those issued under the AIFMD, in order to ensure consistency in the application of the requirements outlined above across member states.
7 Sanctions regime

The impetus for the introduction of a uniform sanctions regime under UCITS V stems from an analysis of national rules on sanctions for breaches of the obligations of the UCITS directive carried out by the Commission. The study revealed that (i) different fines were being imposed by member states for the same category of breaches; (ii) different criteria were being applied by member states in determining the amount of administrative sanctions and (iii) there were variations in sanctions being applied by member states. Again, this resulted in the level of investor protection afforded to UCITS investors varying between member states. The Commission is of the view that competent authorities should be empowered to impose pecuniary sanctions which are sufficiently high so as to be dissuasive and proportionate, so as to offset expected benefits from behaviours which breach requirements.

In order to address this inconsistency between member states, the UCITS V proposals set down an exhaustive list of actions which require sanctions by competent authorities. The proposed directive intends to achieve minimum harmonisation of UCITS sanctioning regimes by providing for a minimum catalogue of administrative sanctions and measures which may be applied in the event of any such breach, including prescriptive limits on fines which may be imposed by competent authorities.

The proposed sanctions regime will apply to breaches of the main investor protection safeguards in the UCITS Directive. These include breaches relating to authorisation requirements, notification / information requirements relating to the holding structure of a management company, requirements relating to organisational rules / rules of conduct and requirements relating to the general activities of UCITS. Certain criteria will be taken into account when determining the appropriate sanction to be applied and these include the gravity and the duration of the breach, the degree of responsibility, the financial strength of the responsible person, the importance of profits gained or losses avoided, the level of cooperation with the competent authority and previous breaches committed.

Other measures to be introduced include an obligation on member states to publish any sanction or measure imposed for a breach of UCITS requirements without undue delay (unless such publication would seriously jeopardise the stability of financial markets). Publication on an anonymous basis is allowed if otherwise would cause disproportionate damage to the parties involved. There is also a requirement for competent authorities and UCITS managers to establish whistle-blowing mechanisms including protection for “whistle-blowers” who report breaches committed by the UCITS to its competent authority. Relevant operators must “have in place appropriate procedures for their employees to report breaches internally through a specified channel.”

Competent authorities must report each year to ESMA aggregated information on measures and sanctions imposed and inform ESMA of any individual measures and sanctions they have published. Management companies, investment companies and depositaries should start thinking about how to adapt their internal governance, organisation and control structures to (i) meet the new requirements on whistle blowing and (ii) make sure that they will be able to prevent behaviour that will expose them in future to much tougher sanctions and an increased risk of reputational damage due to publication.

8 When will UCITS V become national law?

As mentioned above, the European Parliament voted in July 2013 on an amended version of the UCITS V text and the Council of the EU agreed its general approach in December 2013. The draft directive is now the subject of trilogue negotiations between the Council, European Parliament and Commission. Once these institutions reach agreement on the text, the final directive will be published in the Official Journal and member states will have two years from the date of publication to transpose the directive. The transposition date is now likely to fall in 2016. Implementing measures providing greater clarity on certain provisions of UCITS V will also be prepared within this timeframe.

The Commission has indicated in the UCITS V impact statement that it will carry out an economic evaluation three years after the deadline for implementation of UCITS V to determine whether the new rules have increased investor protection, enhanced transparency on remuneration and have fostered investor confidence necessary for the continued relevance of the UCITS retail brand. This evaluation will focus on (i) the extent to which expected cost savings deriving from a clearer and harmonised liability regime for depositaries are realised; (ii) possible impacts of the new delegation and liability rules may have on depositary’s operating costs; (iii) an assessment of the extent to which delegations to non-compliant third country depositaries have occurred and the impact of these; and (iv) an estimate of the impact of any incremental operating costs on UCITS fund costs and returns for investors.
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9 Implications and next steps

In terms of preparation for the changes anticipated by UCITS V, although the application of the new rules is not likely to occur until 2016, UCITS and UCITS management companies will need to consider how the relevant changes will impact on each individual fund’s current custody arrangements in order to prepare for UCITS V.

Depositary banks will need to perform an analysis so as to assess the impact of the new depositary safekeeping, delegation and liability rules on their business. It is widely anticipated that the new liability provisions for depositaries within UCITS V will cause depositaries to review their sub-custody networks and determine if changes are needed to initial and ongoing due-diligence processes. Firms can begin addressing the strategic aspects of the proposals and assessing their capabilities, products and processes. Depositary banks should assess IT requirements (i.e., reporting and record keeping aspects); human resource aspects; and the existing and required processes which will need to be adapted to this new regulatory framework – especially in the management of sub-custodians and other correspondents.

Asset managers will also have to review the existing remuneration policies. In respect of the new remuneration requirements, existing remuneration policies will require amendment, notably with regard to their scope. Management companies should begin to assess which members of staff and which employment contracts will be impacted and they should also begin to think of an approach for setting up a compliant remuneration structure. This may involve changes to the company’s processes, systems and controls, additional data collection, reporting and record keeping. This would involve initial one-off costs to make the appropriate changes and incremental annual compliance costs. Both depositaries and asset managers will also have to do a mapping of the new sanction regime to ensure that they are able to identify risks and smoothly pursue their activities.

A review of the fund prospectus and related documentation, including the business plan, may also be required to take into account the new remuneration requirements, in addition to the very specific new disclosures on the delegation of safekeeping.

Should you have any queries in relation to the content of this brochure, UCITS or Irish investment fund structures generally, please feel free to contact us at the contact details below.