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Recent Developments in UCITS: Part II

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This is the second part in a three-part series on recent developments relating to UCITS. This second part provides a brief overview of the most important changes introduced by UCITS V.

UCITS V

The changes set out in UCITS V were prompted by the financial crisis and the subsequent need to secure stable financial markets. The Madoff fraud and Lehman in particular highlighted the fact that the UCITS Directive has been transposed into national laws in divergent ways and failed to secure the safe and level playing field that the European Commission had planned. The depositary provisions of the AIFMD influenced the Commission's thinking in the area of depositary responsibilities and liability and the Commission recognised that the protection offered to retail investors in UCITS should, as a minimum, be equivalent to the protection offered to institutional investors under the AIFMD.

In reality, the standard of conduct imposed on depositaries under UCITS V is more stringent than the equivalent provision under the AIFMD, in that the UCITS depositary is required to act 'solely' in the interests of the UCITS and its investors.

In drawing up the amendments, the Commission engaged in an impact assessment focusing on five main areas, namely:

(i) eligibility to act as a depositary;

(ii) delegation of depositary functions;

(iii) liability of depositaries;

(iv) remuneration; and

(v) sanctions.

Eligibility to Act as a Depositary

The UCITS rules on the role of depositaries have not changed since the first UCITS Directive was adopted in 1985. UCITS V affirms the principle of a single depositary function (so that one fund cannot have several depositaries) and that the appointment must be evidenced in writing. It also defines the circumstances in which a depositary's safe-keeping duties can be delegated to a sub-custodian (bringing the rules in this regard in line with those applicable under the AIFMD).

Those entities that are capable of acting as a UCITS depositary are: (i) a national central bank; (ii) a credit institution authorised in accordance with CRD IV; and (iii) an authorised legal entity that is subject to certain capital adequacy requirements under the Capital Requirements Regulation (CRR) and CRD IV. There is a grandfathering period, during which UCITS will be permitted to use a depositary that is non-compliant, but every UCITS will have to be compliant in this respect by 18 March 2018.

UCITS V (like the AIFMD) aims to set down a list of uniform rules harmonising the core safe-keeping and oversight functions of depositaries across the EU. These duties include: (i) verifying compliance with applicable rules when UCITS shares are issued, re-purchased, redeemed, cancelled or valued; (ii) verifying that any consideration is remitted to it within the usual time limits; (iii) verifying that the investment company's income is applied in accordance with the law and instruments of incorporation; and (iv) carrying out the instructions of the management or investment company.

Like the AIFMD, UCITS V sets out the duties of a depositary, which include: (i) cash monitoring; (ii) the segregation of assets of the fund from the depositary's own assets; and (iii) a requirement that no cash account associated with the funds' transactions can be opened without the depositary's knowledge. Depositaries must avoid conflicts of interest.

Of note are two principal departures under UCITS V from the AIFMD position on oversight. First, UCITS V places a potentially onerous requirement on depositaries to provide a comprehensive inventory of assets of the UCITS to UCITS managers on a regular basis. This requirement does not just relate to assets over which the depositary has custody or which it physically holds, but all assets of the UCITS in question, which may require depositaries to broaden the scope of their oversight processes. Second, the provisions relating to the reuse of assets of a UCITS scheme by depositaries are more restrictive under UCITS V than the equivalent provisions under AIFMD.

Delegation of Depositary Functions

The new provisions on delegation effectively align UCITS with the AIFMD. Delegation will need to be objectively justified and will be subject to strict requirements regarding the selection and appointment of the sub-custodian. The depositary must monitor the sub-custodian on an ongoing basis.

Where any safe-keeping function is to be delegated by a depositary, details (identifying the delegate and any conflicts of interest) should be included in the UCITS prospectus.

Liability of Depositaries

UCITS V aims to clarify what the depositary's liability will be in the event of the loss of a financial instrument that is held in custody and in doing so to harmonise the liability standard across the EU. In common with the AIFMD, UCITS V imposes strict liability in the event that instruments held in custody are lost. The depositary will be obliged to promptly return to the UCITS a financial instrument of an identical type or of the corresponding amount. The only exception is where the depositary can prove that the loss was due to an "external event beyond its reasonable control and with consequences that were unavoidable despite all reasonable efforts to the contrary." In contrast with the position under the AIFMD (which envisages that the depositary's liability could be discharged where assets are transferred to a sub-custodian), this strict liability will apply under UCITS V, even where the loss occurred with the sub-custodian.

Investors will be able to invoke claims relating to the liability of depositaries either directly or indirectly (through the management company).

All EU member states will be obliged to enact legislation to ensure that in the event of the insolvency of the depositary, the assets held on behalf of the UCITS will not form part of the body of assets available to the depositary's creditors.

Remuneration

Across the financial services industry, the EU is driving regulatory changes designed to ensure that remuneration policies promote sound and effective risk management and discourage risk taking.

Against this background, UCITS V introduces an express obligation on UCITS management companies to establish, for those categories of staff whose professional activities have a material impact on the risk profiles of the UCITS they manage, remuneration policies and practices that are consistent with sound and effective risk management. These categories of staff must include senior management, risk takers, individuals performing controlled functions and any employees receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers. These rules will also apply to UCITS investment companies that do not designate a management company.

Sound remuneration policies must be in line with the business strategy, objectives, values and interests of the management company and the UCITS it manages and based on the following principles:

(i) implementation of the remuneration policy must be reviewed at least annually and the remuneration of senior officers in the risk management and compliance functions directly overseen by a remuneration committee;

(ii) where remuneration is based on performance, it should be on a multi-year cycle and the total amount of remuneration based on a combination of the assessment of the performance of the individual and of the business unit or UCITS concerned and of the overall results of the management company;

(iii) fixed and variable components of total remuneration are appropriately balanced and at least 40 per cent of the variable component is deferred over a period which is appropriate to the life cycle and redemption policy of the UCITS. The variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the management company as a whole

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and justified according to the performance of the business unit, the UCITS and the individual concerned; and

(iv) subject to the legal structure of a UCITS and its rules, a substantial portion (at least 50 percent) of any variable remuneration must consist of units of the UCITS concerned or equivalent ownership interests or share-linked instruments or non-cash instruments, unless the management of the UCITS accounts for less than 50 percent of the total portfolio managed by the management company, in which case the 50 percent will not apply.

Article 14b sets out a number of stipulated principles relating to governance and pay structure and risk alignment, stating that "When establishing and applying the remuneration policies. . .management companies shall comply with the principles in a way that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities." As with the AIFMD remuneration principles, UCITS V requirements are subject to the application of the proportionality principle.

Sanctions

In a move designed to harmonise rules across the EU, UCITS V requires:

(i) a minimum scale of administrative sanctions and fines across EU member states;

(ii) a minimum list of sanctioning criteria; and

(iii) an obligation upon regulators and management companies to establish whistle-blowing mechanisms.

It also should be noted that UCITS V amends UCITS IV to ensure that a regulator is entitled to see existing telephone and data traffic records held by a telecommunications operator, a UCITS, a management company, an investment company or a depositary where a "reasonable suspicion" exists that those records relate to the subject matter of the inspection and may be relevant to prove a breach of the UCITS V Directive.

Conclusion

UCITS V has implications for UCITS funds and their managers of all sizes. The enhanced risk management practices will occupy greater management time and result in an additional compliance cost. Depositaries are set to assume greater responsibility and liability. This will have an effect on the services offered and, inevitably, fee structures. It is likely to put pressure on the profitability of asset managers and part of that cost may need to be passed on to customers.

Preparing for UCITS V necessitates:

(i) a review of existing policies across the business;

(ii) an assessment as to the impact of the rules and how they affect business (including, potentially, the need to amend fund documentation, employee documentation and/or contractual arrangements with third parties); and

(iii) board agreement as to a programme of operational changes necessary to ensure compliance with the new rules in good time.

Global custodians have indicated that they are likely to consider reducing the risk associated with taking on third party liabilities by investing in local custody networks in those markets where they do not already have a presence.

Our next and final part in this series will provide a brief discussion of UCITS VI.

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