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A short guide to recent developments in UCITS

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1. Background

The Undertakings for Collective Investment in Transferable Securities (UCITS) Directives are a set of EU Directives that aim to allow collective investment schemes to operate freely throughout the EU on the basis of a single authorisation from one member state. In practice, many EU Member States have imposed additional regulatory requirements that have impeded free operation with the effect of protecting local asset managers.

The first UCITS Directive was adopted in 1985 and the current and consolidated Directive which governs UCITS is UCITS IV [2009/65/EC], as amended by UCITS V [2014/91/EU], which came into force on 17 September 2014.

UCITS V amends the parts of UCITS IV which deal, amongst others, with depositary functions, remuneration policies and sanctions for failure to comply with the Directive. Member States have until 18 March 2016 to transpose it into national law.

2. General introduction to UCITS schemes

The purpose of the UCITS Directive is to facilitate the cross-border marketing within the EU of open-ended investment funds which are available to the general public, while incorporating certain investor protection mechanisms. The UCITS Directive thus establishes common basic rules for the authorisation, supervision, structure and activities of UCITS schemes in the EU.

A UCITS scheme must be authorised by the Member State in which it is established. Once it is authorised, the scheme may then be promoted in every other Member State, provided it complies with the local marketing regulations, without needing further re-authorisation.

The following provides a brief overview of the UCITS scheme, but for more detailed information regarding UK UCITS, please see our publication entitled: 'UK UCITS and regulated funds' on our website at: www.cummingslaw.com/publications.

Conditions

In order to qualify as a UCITS scheme, a fund must meet the following conditions:

(i) the sole object of the fund must be to invest capital collected from the public in transferable securities and other liquid assets based on the principle of risk spreading;

(ii) units or shares issued by the fund must be directly or indirectly redeemable out of the fund's assets at the request of the unitholders/shareholders i.e. a UCITS fund must be open-ended; and

(iii) the head office of the fund must be situated in the same Member State as the registered office.

Exclusions

The following types of funds are not UCITS schemes:

- Closed-ended funds.
- Funds not directly available to the general public.
- Funds sold only in non-Member States.
- Funds investing in physical assets such as property or commodities.

Investment restrictions

The UCITS Directive imposes several restrictions on the investment policies of a UCITS scheme, including:

(i) in general, it may invest no more than 10% of its assets in transferable securities or approved money-market instruments which are issued by any single body and all holdings in excess of 5% of its assets may not, in aggregate, exceed 40% of the assets;

(ii) no more than 20% of scheme property may be in transferable securities or approved money-market instruments issued by entities in the same group;

(iii) no more than 20% of assets may be invested in any one single collective investment scheme (both UCITS and non-UCITS schemes) with a general restriction of a maximum of 30% of assets invested in non-UCITS schemes;

(iv) maximum over-the-counter counterparty exposure is limited to 5% (10% in the case of approved banks);

(v) no more than 20% of assets may be invested in a combination of transferable securities and approved money-market instruments issued by, and deposits or OTC derivative transactions made with, a single body;

(vi) no more than 35% of assets may be invested in the government or public securities of a single body (subject to (vii) below); and

(vii) over 35% of scheme property may be invested in a single government or public securities body, but there is a restriction that no more than 30% of the scheme property consists of securities of any single issue and a requirement that the securities must come from at least six different issues.

3. 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 that 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.

Turning to each of these points:

(i) 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 which 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 which 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. Firstly, 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. Secondly, 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.

(ii) 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 on-going 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.

(iii) 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.

(iv) 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% 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 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%) 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% of the total portfolio managed by the management company, in which case the 50% 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.

(v) 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 should also be noted that UCITS V amends UCITS IV to ensure that a regulator is entitled to see existing telephone and existing 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.

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 impact 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.

4. UCITS VI

On 26 July 2012 the European Commission released a paper outlining further ideas as to how the UCITS Directive can be improved, which became known as UCITS VI. The Commission's consultation on UCITS VI came very soon after its legislative proposal for the UCITS V Directive, which was also published in July 2012.

The focus of UCITS VI centred on proposals concerning areas other than those addressed by UCITS V and the eight topics raised for discussion in the original UCITS VI consultation include:

(i) eligible assets and the use of derivatives – in particular, whether it is necessary to limit the scope of eligible derivatives and the use of derivatives generally to those traded on multilateral platforms and cleared by a central counterparty;

(ii) efficient portfolio management techniques – whether the current criteria (on eligibility, liquidity and diversification for example) requires amendment;

(iii) OTC derivatives – how OTC derivative transactions should be dealt with when assessing UCITS limits on counterparty risk;

(iv) extraordinary liquidity management rules – whether there is a need for a common framework for dealing with liquidity bottlenecks in exceptional cases or otherwise;

(v) depositary passport – whether a depositary passport should be introduced and how this would work in practice;

(vi) money market funds – whether they present a source of systemic risk and/or do they need harmonised regulation at EU level;

(vii) long-term investments – (a) how access can be afforded to retail investors and how this could be implemented and regulated; (b) what proportion of a fund's portfolio should be dedicated to such assets; and (c) whether diversification rules are necessary to secure adequate liquidity;

(viii) improvements to the UCITS IV framework – for example Article 64(1) of the UCITS Directive requires UCITS to provide information to investors in the following two cases: (i) where an ordinary UCITS converts into a feeder UCITS; and (ii) where a master UCITS changes. As it stands, this does not cover a third possible scenario, namely where a feeder UCITS converts into an ordinary UCITS. Such conversions may lead to a significant change in the investment strategy.

5. Next Steps

There is no indication as to when UCITS VI will be introduced and it is no longer clear whether a UCITS VI legislative proposal will be published at all, as the more pressing issues referenced in UCITS VI have been, or are in the process of being, dealt with via other measures. Steven Maijoor, ESMA chairman, gave the proposed Money Market Funds Regulation as an example of this in a speech given in November 2014 and said that he would favour first taking some time to ensure that the UCITS framework, as amended most recently by UCITS V, is implemented correctly and that national regulators are applying it in a convergent manner rather than introducing new or different requirements, such as UCITS VI. Similarly, the FCA had said that in its Business Plan for 2013/14 it would continue to feed into the development and publication of the Level 1 text of UCITS VI following its predecessor's, the FSA, and HM Treasury's joint response to the July 2012 consultation. However, there was no reference to UCITS VI in the Business Plan for 2014/15 and a UCITS VI legislative resolution has not been published.

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