UCITS V Directive

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Background

In July 2012, the EU Commission (the “Commission”) released a proposal on the revision of the Undertaking for Collective Investment in Transferable Securities (“UCITS”) regime in respect of depositary functions, remuneration policies and sanctions relating to UCITS (“UCITS V”).

The proposed amendments to the existing UCITS regime aim to address lessons learned from the financial crises, most notably in connection with the Madoff incident which highlighted a number of issues relating to inconsistency between member states of the EU (“Member States”) in applying the provisions of the UCITS directive. 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.

UCITS V focuses on three main areas; namely (i) clarification of the UCITS depositary’s functions and liability in circumstances where assets are lost in custody, (ii) rules governing remuneration policies which UCITS will be obliged to introduce and (iii) the harmonisation of the minimum administrative sanctions regime across Member States.

We examine each of these areas in greater detail below.

Depositary Role

The core function of the depositary is the protection of the investors in the relevant fund structure. Accordingly, UCITS V addresses eligibility criteria applicable to depositaries, circumstances in which delegation is permitted and the liability of such entities to the underlying investors.

Eligibility

While the existing UCITS framework requires that depositaries must be institutions which are subject to prudential regulation and on-going supervision, each Member State can determine which categories of institutions shall be eligible to act as depositories to UCITS funds.

This has led to legal uncertainty and inconsistency amongst Member States, which in turn leads to different levels of investor protection.

The Commission has sought to address the legal uncertainty this flexibility has created by setting out an exhaustive list of entities which are eligible to act as depositories of UCITS funds. The Commission has recommended in its proposal that only (i) credit institutions and (ii) MiFID investment firms that provide safekeeping and administration services authorised and regulated within the EU may act as depositories, with grandfathering provisions proposed for existing depositaries of UCITS in order to give them an opportunity to convert themselves into eligible entities. The Commission noted in this regard that each of these categories of depositories will provide sufficient guarantees in terms of prudential regulation, capital requirements and effective supervision.

It is noteworthy that while the Alternative Investment Fund Managers Directive (the "AIFM Directive") provides that a third category (namely other entities which are subject to prudential regulation and ongoing supervision) could be eligible to act as depository of alternative investment funds, this third category has not been included in UCITS V.

Because the AIFM Directive cross-refers to the provisions of the UCITS directive which are being amended, this may result in the eligibility criteria for depositories of non-UCITS funds being indirectly restricted. The one concern is therefore that this provision will reduce competition in the market place which may not be of benefit to investors. Consequently there is merit in the above referenced third category being included in the finalised proposal.

Delegation

Given that UCITS may now invest in an increasingly complex array of financial instruments and in many markets outside of the EU, fund managers now often require depositaries to appoint sub-custodians in third country markets. However, as seen from the Madoff and Lehman cases, the use of local sub-custody networks can pose considerable risks to a UCITS.

To this end, UCITS V provides that a depository may only delegate all or part of its safekeeping tasks to a sub-custodian where certain conditions are satisfied, including inter alia, the depository demonstrating that there is an objective reason for the delegation and that "*all due skill, care and diligence in the selection and the appointment of any third party to whom it wants to delegate parts of its tasks, and keeps exercising all due skill, care and diligence in the periodic review and ongoing monitoring of any third party to whom it has delegated parts of its tasks and of the arrangements of the third party in respect of the matters delegated to it.*"

It is expected that further clarity on each of these requirements will be provided through the Commission adopting delegated acts in due course.

Specific requirements relate to the appointment of a delegate where the function delegated is the safekeeping of financial instruments which may be held in custody i.e. 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.

In circumstances where the appointment of a sub-custodian is required under local law, the depositary may appoint a local entity which does not satisfy the delegation requirements set out in UCITS V 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.

UCITS V clarifies that entrusting the custody of assets to the operator of a securities settlement system is not considered a delegation of custody functions.

One proposal which is a concern is the requirement that a UCITS discloses in its prospectus the identity of any delegates appointed by a depositary and any conflicts of interest which arise from such a delegation. While it is acknowledged that this information should be made available to investors (as required under the AIFM Directive), it should not be necessary for such information to be disclosed in the prospectus as any such requirement would introduce significant operational and practical challenges, as well as increasing the costs borne by the end investor.

Liability

Since the adoption of the UCITS Directive in 1985, the rules relating to depositaries have remained mostly unchanged.

Under the existing UCITS regime, the depositary is only held liable to the UCITS and its unitholders for any loss suffered by them as a result of (i) its unjustifiable failure to perform its obligations or (ii) its improper performance of such duties.

However, there has been an inconsistent interpretation across Member States of these two terms, resulting in a situation where the liability standard of the depositary is not identical amongst Member States. This has resulted in UCITS investors being provided with different levels of protection depending on the domicile of the UCITS in which they have invested.

In relation to liability, UCITS V distinguishes between assets that are capable of being held in custody and those that are not, where a record keeping and ownership verification applies instead.

While the existing UCITS directive is silent as to responsibility in case of the loss of an asset, under the UCITS V proposal, a depository of a UCITS will be liable for the loss by the depository or a sub-custodian to whom custody has been delegated irrespective of fault or negligence, with the exception of losses caused by external events beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.

In case of a loss of a financial instrument held in custody, the depository will be obliged to return identical financial instruments or a corresponding amount of assets (where they are capable of substitution, e.g. cash) to the UCITS without undue delay.

In all other cases (i.e. other than the loss of a financial asset), UCITS V proposes that the depository should be liable to the UCITS and the investors of a UCITS if a loss is suffered as a result of the depository's negligence or intentional failure to properly fulfil its obligations under the UCITS directive.

In relation to delegation, UCITS V provides that the liability of the depositary shall not be affected by any delegation. As a result, in case of a loss of a financial instrument held in custody, the depositary is obliged to return the instrument even if the loss occurred with the sub-custodian.

While the liability provisions largely reflect the liability provisions applicable to depositories under the AIFM Directive, one notable distinction between the two liability regimes is that depositories of UCITS will not be permitted to exclude or limit their liability under contract whereas depositaries of alternative investment funds may transfer liability for the loss of financial instruments held in custody to the relevant sub-custodian. This means that investor protection in the case of UCITS funds is higher than those afforded to investors in alternative investment funds with the Commission noting in its proposal 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.

To date, the issue of liability in the case of delegation is dealt with differently in different Member States given the lack of rules relating to same in the UCITS directive. This has caused considerable legal uncertainty as to the extent to which a depositary is liable for losses at the sub-custodian level.

UCITS V seeks to eliminate this legal uncertainty by confirming that a depositary will be liable in circumstances where it delegates custody tasks and the financial instruments held in custody by a third party are lost.

Given the liability risk faced by depositories of UCITS funds, it is likely that there will be an impact on fees charged by these institutions for the provision of depositary services, thereby negatively impacting the end investor. In addition, depositaries may also refuse to provide custodial services in certain markets on the basis that such markets do not provide the depositary with sufficient safeguards to exercise its duties in a satisfactory and prudent manner. This may indirectly impact the investment decisions of a UCITS which presumably is not the intention of these provisions.

UCITS V also proposes to give new rights to all UCITS investors so that they are able to directly or indirectly have recourse to the UCITS depository.

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. The proposed Article 22(3) of the UCITS directive details the oversight obligations of the depositary while the proposed Article 22(5) of the UCITS directive sets down the responsibilities which fall within the remit of “safe-keeping of assets”, distinguishing between (i) custody duties relating to financial instruments which can be custodied by the depositary and (ii) record keeping and ownership verification requirements applicable in the case of the remaining types of assets.

Similar to provisions included in the AIFM Directive, UCITS V imposes an obligation on the depository to ensure that the cash flows of UCITS are properly monitored and in particular to ensure that all payments made by or on behalf of an investor 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 meet certain conditions. Again, the intention behind this is to increase investor protection by reducing the possibility of fraudulent cash transfers. Requirements relating to the segregation of UCITS’ assets from those assets of the depositary have also been included to protect such assets in the event of a default by the depositary or its delegate.

Further guidance on these requirements will be provided by the Commission in implementing measures which will be adopted once UCITS V has been finalised.

Remuneration Policies

Remuneration of UCITS managers is usually based on a NAV based fee which means that there is an incentive for those managing UCITS to increase risk in order to increase potential returns. The existing UCITS framework does not include any general principles on remuneration of those involved in the management of UCITS funds. Given that remuneration and incentive schemes within financial institutions are thought to be one of the key factors in the recent financial crises, the Commission has sought to introduce sound remuneration principles in UCITS V.

Consistent with the approach adopted in the AIFM Directive, UCITS V proposes to oblige UCITS management companies to establish and apply remuneration policies and practices (covering salaries and discretionary pension benefits) which will promote effective risk management and discourage excessive risk-taking which is inconsistent with the risk profiles or fund rules governing the relevant UCITS. These remuneration policies and procedures will 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. Recital 2 to UCITS V suggests that such rules shall apply also to UCITS self-managed investment companies.

Measures set down in UCITS V include for example (i) a requirement that the remuneration policy adopted is audited at least annually to ensure compliance with the policies and procedures adopted by senior management, (ii) a ban on guaranteed variable remuneration except in exceptional circumstances, (iii) a requirement that at least 50% of any variable remuneration is in the form of units of the UCITS, (iv) payments made under the early termination of a contract are structured in a way which does not reward failure and (v) a requirement that a portion of the variable remuneration is deferred and is only paid after a certain period if sustainable taking into account the financial performance of the management company or UCITS as a whole.

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. It is hoped that this disclosure obligation will increase investor confidence and transparency within the UCITS arena.

It is expected that the European Securities and Markets Authority (ESMA) will issue guidelines on sound remuneration policies in order to ensure consistency in the application of the requirements outlined above across Member States.

Regulatory Sanctions

Chapter XII of the existing UCITS directive sets down broad principles relating to the supervisory and investigatory powers granted to the competent authorities of each Member State. It also provides that the measures and penalties to be imposed following infringements of the UCITS directive are left to the discretion of each Member State.

An analysis of national rules on sanctions for breaches of the obligations of the UCITS directive carried out by the Commission 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 the use of sanctions by Member States. This resulted in the level of investor protection afforded to UCITS investors varying from Member State to Member State.

In order to address this inconsistency between Member States, UCITS V sets down an exhaustive list of actions which require sanction by competent authorities. The proposal also sets out a minimum list 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. Prescriptive criteria to be taken into account when determining the type of administrative sanctions or measures to be taken by a competent authority are also set out.

Other measures being introduced relating to sanctions imposed by competent authorities include (i) an obligation on Member States to publish any sanction or measure imposed for a breach of UCITS requirements (unless such publication would seriously jeopardise the stability of financial markets) and (ii) protection for “whistleblowers” who report breaches committed by the UCITS to its competent authority.

Proposed Timeline for Implementation

The UCITS V proposal has been forwarded to the European Parliament and the European Council for their consideration under the co-decision procedure. Once the final text of UCITS V has been agreed upon, Member States usually have 2 years to transpose the provisions into national law. Implementing measures providing greater clarity on certain provisions of UCITS V will also be prepared within this time frame. Given that UCITS V is expected to be a priority for the Irish EU Presidency which runs from January to June 2013 and presuming that negotiations are concluded within 2013, new rules could take effect from 2015.

Monitoring and Evaluation of UCITS V by the Commission

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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