UCITS V

Status

On 23 July 2014 the European Council formally adopted the final text of the UCITS V directive (the **Directive**). The European Parliament had formally adopted the agreed text in April 2014. It is expected that the Directive will be published in the European Union's official journal (**OJ**) during quarter 3 of 2014. It will come into force 20 days after publication and Member States will have 18 months to transpose the Directive into national law. Further, depositories will be given an additional 24-month transition period after the transposition deadline.

The full requirements of UCITS V will not be known for some time, however, as the Directive empowers the European Commission (the **Commission**) to adopt delegated acts, giving detail to some of the new provisions introduced in the Directive. Further, the Directive provides that the European Securities and Markets Authority (**ESMA**) is to bring forward guidelines on sound remuneration policies and practices in the asset management sector, similar to those it introduced for the Alternative Investment Fund Managers Directive (**AIFMD**). Whereas it is anticipated that ESMA will introduce these guidelines in a relatively straightforward manner, the implementing regulations required from the Commission will not be a straightforward process, and industry engagement will be key over the coming months.

Background

UCITS V was introduced in response to the various financial crises (such as Madoff and Lehman) and is in line with other global and EU initiatives such as banking reform and AIFMD. The key elements of the Directive are as follows:

- it revises the depositary regime as regards depositary eligibility, duties, responsibilities and liabilities and defines the conditions in which safekeeping duties can be delegated to a sub-depositary;
- it introduces rules governing remuneration policies of UCITS managers consistent with those under AIFMD and the Fourth Capital Requirements Directive (**CRD IV**);
- it introduces a formalised whistleblowing regime; and
- it aims to harmonise the minimum administrative sanctions regime across member states.

Remuneration

UCITS management companies (in common with Alternative Investment Fund Managers under the AIFMD) will be obliged to implement remuneration policies and practices which are consistent with and which promote sound and effective risk management, do not encourage risk-taking which is inconsistent with the risk profiles and rules of the UCITS they manage, and do not impair compliance with the management company's duty to act in the best interests of the UCITS.

These remuneration policies and practices will have to include fixed and variable components of salaries and discretionary pension benefits. The policies and practices will apply to senior management, risk takers, control functions, and employees receiving total remuneration that falls within the remuneration bracket of senior management and risk takers whose professional activities have a material impact on the risk profile of the management companies or of the UCITS they manage.

At least half of fund managers' variable remuneration must be paid in the assets of the UCITS (or equivalent), unless the management of UCITS accounts for less than half of the total portfolio. Payment of at least 40% of variable remuneration will also be required to be deferred for at least three years (this rises to 60% for particularly high variable components). The implementation of the remuneration policy is subject to annual review.

More detail on remuneration under the Directive

When establishing and applying the remuneration policies, management companies will have to comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities (so proportionality applies):

a. the remuneration policy must be consistent with and promote sound and effective risk management and must not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS they manage;

b. the remuneration policy must be in line with the business strategy, objectives, values and interests of the management company and the UCITS it manages and the investors of such UCITS, and include measures to avoid conflicts of interest;

c. the remuneration policy must be adopted by the management body of the management company in its supervisory function (in Ireland, this will likely be the board of Directors and this is assumed in this note). The board must adopt and at least annually review the general principles of the remuneration policy. The board is responsible for and must oversee the implementation of the remuneration policy. These duties must be performed by directors who do not perform any executive functions in the management company and who have expertise in risk management and remuneration.

d. the implementation of the remuneration policy must be subject to at least annual central and independent internal review for compliance with the policies and procedures for remuneration adopted by the board;

e. staff engaged in control functions must be compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;

f. the remuneration of the senior officers in the risk management and compliance functions must be directly overseen by the remuneration committee, if such committee exists;

g. where remuneration is performance related, the total amount of remuneration must be based on a combination of the assessment of the performance of the individual and of the business unit or UCITS concerned and their risks and of the overall results of the management company, and when assessing individual performance, financial as well as non-financial criteria must be taken into account;

h. the assessment of performance must be set in a multi-year framework appropriate to the holding period recommended to the investors of the UCITS managed by the management company in order to ensure that the assessment process is based on longer term performance of the UCITS and its investment risks and that the actual

payment of performance-based components of remuneration is spread over the same period;

i. guaranteed variable remuneration should be exceptional, should occur only in the context of hiring new staff and should be limited to the first year;

j. fixed and variable components of total remuneration should be appropriately balanced and the fixed component should represent a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component;

k. payments related to the early termination of a contract should reflect performance achieved over time and should be designed in a way that does not reward failure;

l. the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components should include a comprehensive adjustment mechanism to integrate all relevant types of current and future risks;

m. subject to the legal structure of the UCITS and its fund rules, a substantial portion, and in any event at least 50% of any variable remuneration should consist of units of the UCITS concerned, or equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments with equally effective incentives as any of the above, unless the management of UCITS accounts for less than 50% of the total portfolio managed by the management company, in which case the minimum of 50% does not apply. These instruments should be subject to an appropriate retention policy designed to align incentives with the interests of the management company and the UCITS it manages and the investors of such UCITS. Member States or their competent authorities may place restrictions on the types and designs of those instruments or ban certain instruments as appropriate. This applies to both the portion of the variable remuneration component deferred in line with point (n) and the portion of the variable remuneration component not deferred;

n. a substantial portion, and in any event at least 40 %, of the variable remuneration component, should be deferred over a period which is appropriate in view of the holding period recommended to the investors of the UCITS concerned and should be correctly aligned with the nature of the risks of the UCITS in question. The deferral period should be at least three years; remuneration payable under deferral arrangements should vest no faster than on a pro-rata basis; where a variable remuneration component is of a particularly high amount, at least 60 % of the amount should be deferred;

o. the variable remuneration, including the deferred portion, should be paid or vest 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. The total variable remuneration should generally be considerably reduced where subdued or negative financial performance of the management company or of the UCITS concerned occurs, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus[1] or clawback arrangements;

p. the pension policy should be in line with the business strategy, objectives, values and long-term interests of the management company and the UCITS it manages. If the employee leaves the management company before retirement, discretionary pension benefits should be held by the management company for a period of five years in the form of instruments set out in point (m). In the case of an employee reaching retirement, discretionary pension benefits should be paid to the employee in the form of instruments referred to in point (m), subject to a five year retention period;

q. staff should undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;

r. variable remuneration should not be not paid through vehicles or methods that facilitate the avoidance of these requirements.

The principles listed above will apply to any benefit of any type paid by the management company, to any amount paid directly by the UCITS itself, **including performance fees**, and to any transfer of units or shares of the UCITS, made to the benefits of those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that falls into the remuneration bracket of senior management and risk takers, whose professional activities have a material impact on their risk profile or the risk profile of the UCITS they manage. This means that delegated investment managers will need to comply with the remuneration code.

Remuneration Committee

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 must establish a remuneration committee. The remuneration committee shall be constituted in a way that enables it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk.

The remuneration committee set up, where appropriate, in accordance with ESMA guidelines will be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the management company or the UCITS concerned and which are to be taken by the board. The remuneration committee shall be chaired by a director who does not perform any executive functions in the management company concerned. The members of the remuneration committee must be directors who do not perform any executive functions in the management company concerned.

If employee representation on the management body is provided for by national law (this is not the norm in Ireland), the remuneration committee must include one or more employee representatives. When preparing its decisions, the remuneration committee must take into account the long-term interest of investors and other stakeholders and the public interest.

Prospectus/KIID Disclosure

The UCITS prospectus must set out a significant level of detail regarding remuneration, remuneration policy and who sets it. Moreover, the KIID must give details on the policy and how to access information on remuneration.

ESMA Guidelines

As noted above, ESMA is to issue guidelines on sound remuneration policies in the asset management sector. The guidelines will look at the persons to whom remuneration policies and practices apply and the adaptation of the remuneration principles to the size of the management company and the size of UCITS they manage, their internal organisation and the nature, scope and complexity of their activities. The Directive states that ESMA is to consult the European Banking Authority in developing these guidelines, and that they should be based on those introduced for AIFMD and CRD IV. The aim is that remuneration principles should be aligned insofar as possible with AIFMD, and ensure consistency with requirements developed for other sectors of financial services, in particular credit institutions and

investment firms. The guidelines will also aim to include provisions on how different sectoral remuneration principles, such as those in AIFMD and CRD IV, are to be applied where employees or other categories of personnel perform services subject to different sectoral remuneration principles.

Depositary

Eligibility to act as a depositary

Once UCITS V is in force, UCITS depositaries can be

- a national central bank;
- a credit institution authorised in accordance with CRD IV; or
- another legal entity authorised by a national competent authority under the UCITS Directive, which is subject to capital adequacy requirements equivalent to CRR, holding own funds equivalent to CRD IV and subject to prudential regulation, ongoing supervision and minimal requirements.

These are broadly in line with (although somewhat narrower than) AIFMD provisions.

Grandfathering

Existing UCITS depositories that do not meet the new eligibility requirements will be given an additional 24-month transition period after the transposition deadline to gain the necessary authorisation to continue as a UCITS depositary. A depositary cannot also act as the investment company or management company. An investment company and, for each fund it manages, a management company, must appoint a single depositary, this must be evidenced by a written contract which (inter alia) regulates the flow of information. The delegated regulations to be introduced by the Commission will set out the conditions to be included in the contract between the investment company and the depositary. These delegated regulations will also set out the due diligence duties of depositories, the rules for segregation of assets, and the conditions for performing depositary duties. These are each discussed in more detail below.

Depositary duties

Member states must ensure that where the depositary and/or any third party located in the EU, to whom custody of UCITS assets has been delegated, becomes insolvent, the UCITS assets will not be available to the depositary or third party's creditors.

As regards cash monitoring, UCITS V will mirror AIFMD and the depositary must ensure that all subscription payments have been received and all cash is booked correctly in cash accounts that are opened in the name of the UCITS, the name of the management company acting in the name of the UCITS or the name of the depositary acting on behalf of the UCITS. In order to ensure segregation of assets, where the cash account is opened in the name of the depositary acting on behalf of the UCITS, none of the depositary's own cash may be deposited in that account. The Directive sets out the depositary's duties regarding cash monitoring and safe-keeping, distinguishing between assets in custody (meaning assets capable of registration/physical delivery) and other assets.[2]

Where financial instruments can be held in custody, the depositary must hold in custody all financial instruments that may be registered in a financial instruments account opened in the depositary's books and all financial instruments that can be physically delivered to the depositary and the depositary must ensure that all those financial instruments that can be registered in a financial instruments account opened in the depositary's books are registered in the depositary's books within segregated accounts (in accordance with MiFID), opened in the name of the UCITS or the management company acting on behalf of the UCITS, so that they can be clearly identified as belonging to the UCITS.

The assets held in custody by the depositary will only be allowed to be reused if:

1. the reuse of the assets is executed for the account of the UCITS,
2. the depositary is carrying out the instructions of the management company on behalf of the UCITS,
3. the reuse is for the benefit of the UCITS, and
4. the interest of the unit-holders and the transaction is covered by high quality and liquid collateral received by the UCITS under a title transfer arrangement.

The market value of the collateral at all times has to amount to at least the market value of the reused assets plus a premium.

In performing its duties, the depositary must act honestly, fairly, professionally, independently and in the interest of the UCITS and its investors.

Delegation of Depositary Duties

In general, the conditions and requirements for delegation to a sub-depositary are aligned with AIFMD.

The Directive sets out due diligence and on-going monitoring requirements and conditions upon which the depositary's safekeeping duties can be delegated to a sub-depositary. The depositary must be able to show that that there is an objective reason for the delegation. As regards the due diligence to be carried out before a sub- depositary is appointed, the depositary must be able to show that "the depositary has exercised 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." This is generally in line with the current requirements of the Central Bank of Ireland (Central Bank).

The Directive provides that the depositary can only delegate to a third party who at all times satisfies a number of requirements. These include:

- a requirement on the delegate to segregate the assets from its own assets,
- a requirement on both parties that, in the event of the insolvency of the delegate, assets held in custody on behalf of the UCITS must be unavailable for distribution to or realisation for the benefit of the delegate's creditors, and
- a requirement on the depositary that, where the delegate holds assets in custody, the delegate is subject to effective prudential regulation, including being subject to minimum capital requirements, and is subject to external periodic audit to ensure that the assets are in its possession.

Of practical assistance to depositaries are the provisions that where the local law requires that certain assets are held in custody by a local entity and there are no local entities that satisfy the delegation requirements, the depositary can delegate its functions to such local entity provided investors have been informed and the UCITS or the management company (on behalf of the UCITS) instructed the depositary to delegate to such local entity. Moreover, the provision of services by securities settlement systems is not considered a delegation of custody functions. Depositaries will need to update the agreements with sub- depositaries to ensure that all of the requirements are reflected in the agreement. The indemnity provisions in the sub-depositary agreement may need to be refined so that sub-depositaries indemnify the

depositary in the event of a loss of any assets held by such sub-depositary. The reason for this is that the depositary will ultimately be liable for the loss of any assets held by a delegate.

Depositary liability

Under the existing UCITS IV framework, the standard of liability for loss of a financial instrument held in custody is that liability arises in case of "unjustifiable failure to perform obligations" or "improper performance" of such duties. These words have been interpreted differently in various member states, and this has resulted in different levels of investor protection. The Directive will harmonise depositary liability by introducing the following provisions:

- The depositary will be liable to the UCITS and to the unit holders of the UCITS for the loss by the depositary or a third party to whom the custody of financial instruments held in custody has been delegated.
- In case of a loss of a financial instrument held in custody, the depositary must return a financial instrument of identical type or the corresponding amount to the UCITS or the management company acting on behalf of the UCITS without undue delay if it is deemed liable for the loss.
- The depositary shall not be liable if it can prove that the loss has arisen as a result of 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-depositary.
- Apart from the case of the loss of a financial asset, the depositary will also be liable to the UCITS and its investors for all other losses suffered by them as a result of the depositary's negligent or intentional failure to properly fulfil its obligations under the Directive.
- The Directive 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.
- Investors may invoke the liability of the depositary directly or indirectly through the management company or the investment company provided this does not lead to duplication of redress or to unequal treatment of investors.
- The depositary bears the burden of proof in demonstrating that it has duly performed its duties.
- Unlike the AIFMD regime, depositaries of UCITS will not be permitted to exclude or limit their liability under contract.

Whistleblowing

UCITS V also introduces whistleblowing procedures aimed at encouraging employees of UCITS management companies to report breaches of relevant rules to the relevant regulatory authorities.

Sanctions

The sanctions regime is to be revised in order to tackle the differences between member states in the criteria being applied in issuing sanctions and in the level of sanctions being applied to specific breaches. UCITS V harmonises how breaches are to be sanctioned so that sanctions act as an effective disincentive, and sanctions are to be compiled and reported on a Europe-wide basis.

Level 2 measures

As noted at the start, The Commission will adopt Level 2 measures on topics such as defining more specifically the depositary's initial and on-going due diligence duties regarding the selection and appointment of a sub-depositary and the circumstances in which financial instruments held in custody should be considered as lost.

[1] malus: arrangement that permits the management company to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performance. Malus is a form of ex-post risk adjustment.

[2] Assets which are not capable of being held in custody in the same manner as securitised assets include, for example, OTC derivatives, which are contractual rights not capable of physical custody. The depositary must verify ownership of such OTC derivatives and keep a record of such derivatives. The depositary must provide the management company or the investment company, on a regular basis, with a comprehensive inventory of all of the assets of the UCITS.

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