

UCITS V DIRECTIVE—OVERVIEW AND PRACTICAL IMPLICATIONS

Date: 13 October 2015

Investment Management Alert

By: Andrew J. Massey, C. Todd Gibson, Sean Donovan-Smith

Changes to the UCITS Directive^[1] (known as "**UCITS V**") were published in the Official Journal of the European Union and came into force on 17 September 2014. EU Member States are required to transpose UCITS V into national law by 18 March 2016.

The UCITS V provisions seek to address certain perceived weaknesses in the UCITS regime, particularly following the Madoff fraud and the default of Lehman Brothers. In addition, certain provisions of UCITS V seek to align the UCITS regime with the Alternative Investment Fund Managers Directive^[2] ("**AIFMD**"), and to harmonise regulation across the EU. The key aspects addressed by UCITS V relate to the depositary function, remuneration of personnel and regulatory sanctions.

DEPOSITARY FUNCTION

To date, the UCITS Directive has imposed high-level requirements relating to the depositary function. These include a requirement that the assets of a UCITS are entrusted to a depositary for safe-keeping, and requirements relating to the eligibility to act as a depositary and the depositary's material relationships with the manager and its delegates. The enactment of more detailed provisions by individual Member States has resulted in the adoption of different approaches across the European Union. This will change under UCITS V through the introduction of various additional requirements, which we summarise below.

Eligibility to act as a depositary

To address divergent approaches between Member States as to eligibility to act as a UCITS depositary, UCITS V lists the institutions that may act as a UCITS depositary. These are:

- national central banks;
- credit institutions; and
- other legal entities authorised by the competent authority under the laws of a Member State to carry out depositary activities under UCITS V, which are subject to capital adequacy requirements, ongoing supervision and certain minimum requirements (including regarding the custody infrastructure, the adequacy of internal policies and procedures, and governance).

Appointment of single, independent depositary evidenced in writing

UCITS V clarifies that a UCITS shall have a single depositary, and prohibits a company from acting as both a management company and a depositary. The appointment of the depositary must be evidenced by a written contract, which must regulate the flow of information necessary to enable the depositary to perform its functions.

High-level duties of depositary

A depositary shall act honestly, fairly, professionally, independently and solely in the interest of the UCITS and the investors of the UCITS.

The depositary is required to identify and manage conflicts of interest in the performance of its functions. It shall not carry out activities with regard to the UCITS or the management company on behalf of the UCITS that may create conflicts of interest between the UCITS, the investors in the UCITS, the management company and itself, unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the UCITS.

The depositary function

UCITS V sets out the three principal functions of a depositary as:

- the cash monitoring function;
- the safe-keeping function; and
- the oversight function.

Cash monitoring function

The depositary is responsible for ensuring the cash flows of the UCITS are properly monitored. That responsibility includes, in particular:

- ensuring investors' subscription amounts and all cash belonging to the UCITS are booked in accounts with a credit institution, central bank or third country bank, opened in the name of the UCITS, or its management company or depositary on behalf of the UCITS;
- for cash accounts opened in the name of the depositary on behalf of the UCITS, ensuring such accounts are not used for the depositary's own funds.

For such purposes, the depositary must be aware of all cash accounts opened for or otherwise associated with transactions of the UCITS.

Safe-keeping function

The assets of a UCITS are required to be entrusted to a depositary for safe-keeping. Previously, the UCITS Directive did not specify the detailed duties applicable to custodianship. Under UCITS V, there are detailed provisions regarding the custody of financial instruments and other assets.

For financial instruments:

- the depositary must hold in custody all financial instruments that can 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;
- financial instruments registered in a financial instruments account must be registered in the depositary's books within segregated accounts opened in the name of the UCITS or its management company on behalf of the UCITS;

- the re-use of assets held in custody by the depositary is restricted and is only permissible where certain requirements are satisfied (for example, any re-use must be for the benefit of the UCITS and in the interest of investors); and
- the depositary must ensure that, in the event of the insolvency of the depositary and/or any EU-based sub-custodian, the assets of the UCITS held in custody are ring-fenced (*i.e.*, unavailable for distribution to or realisation for the benefit of the creditors of the depositary or the sub-custodian).

For the custody of other assets:

- the depositary must verify the ownership of such assets by the UCITS, or the management company on behalf of the UCITS;
- verification of ownership should be based on information or documents provided by the UCITS or its management company and, where available, external evidence; and
- the depositary must maintain records of such assets where the depositary is satisfied that ownership is verified.

Oversight duties

The responsibility of the depositary to monitor the operation of a UCITS is required to encompass:

- ensuring the sale, issue, re-purchase, redemption and cancellation of units of the UCITS are carried out in accordance with applicable national laws and the fund rules or instruments of incorporation;
- ensuring the value of the units of the UCITS is calculated in accordance with applicable national laws and the fund rules or instruments of incorporation;
- carrying out the instructions of the management company or investment company unless they conflict with applicable national laws or the fund rules or instruments of incorporation;
- ensuring that for transactions involving the assets of the UCITS, any consideration is remitted to the UCITS within the usual time limits; and
- ensuring the income of the UCITS is applied in accordance with applicable national laws and the fund rules or instruments of incorporation.

Delegation of depositary's duties

UCITS V clarifies that the only function a depositary is permitted to delegate is its safe-keeping function. UCITS V also specifies the various conditions the depositary must satisfy in respect of the delegation of its safe-keeping function, including:

- demonstrating there is an objective reason for the delegation;
- that the intention is not to avoid the requirements of the UCITS Directive;
- exercising all due skill, care and diligence in the selection and appointment of any sub-custodian;
- undertaking periodic reviews and ongoing monitoring of sub-custodians with all due skill, care and diligence; and

- ensuring the sub-custodian at all times satisfies a number of requirements, including segregating the assets of the clients of the depositary from the sub-custodian's own assets and from the assets of the depositary in a way that the assets can, at any time, be clearly identified as belonging to the clients of the depositary.

Depositary liability for loss of financial instruments held in custody

UCITS V requires depositaries to be liable to the UCITS and investors for:

- the loss of a financial instrument held in custody by the depositary or a sub-custodian, unless the depositary can prove that the loss arose as a result of an external event beyond its control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary; and
- all other losses suffered by them as a result of the depositary's negligent or intentional failure to properly fulfil its obligations.

If a financial instrument is lost, the depositary will be required to return a financial instrument of an identical type or the corresponding amount to the UCITS or management company acting on behalf of the UCITS without undue delay.

The UCITS V depositary liability provisions are similar to the AIFMD, and it is not possible for the depositary to discharge its liability by transferring it by agreement to its sub-custodian. The liability of the depositary shall not be affected by any delegation to a third party and may not be excluded or limited by agreement.

REMUNERATION OF PERSONNEL

UCITS V introduces requirements relating to the remuneration of key personnel involved in the management and operation of UCITS. The key aspects of the UCITS remuneration regime are set out below.

Remuneration policy and practices

UCITS managers must establish and apply remuneration policies and practices that are consistent with, and promote sound and effective risk management. Such policies and practices must not encourage risk taking which is inconsistent with the risk profile, rules or instrument of incorporation of the UCITS, and must not impair compliance with the UCITS manager's duty to act in the best interest of the UCITS.

Application to key personnel

The remuneration requirements apply to categories of staff whose professional activities have a material impact on the risk profile of the management company or the UCITS.

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 shall establish a remuneration committee.

Proportionality

UCITS managers are required to comply with the remuneration 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.

Fixed and variable components

- Remuneration should comprise both fixed and variable components. For this purpose, variable remuneration is regarded as remuneration which is awarded on the basis of performance criteria.
- Regarding the balance between the fixed and variable components of remuneration, this should be appropriately balanced and the fixed component should represent a sufficiently high proportion to allow the firm to operate a fully flexible bonus policy.
- Variable remuneration should generally not be guaranteed. The award of variable remuneration should be dependent on an assessment of the individual's performance.
- A substantial proportion (at least 50%) of any variable remuneration shall consist of units of the UCITS concerned, equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments with equally effective incentives.
- A substantial proportion (at least 40%) of any variable remuneration shall be deferred over a period which is appropriate in view of the holding period recommended to investors of the UCITS and aligned to the risks of the UCITS (which shall be at least 3 years).
- The UCITS manager shall disclose details of its remuneration policy and practices either in the UCITS' prospectus or on its website (provided that if disclosed on the manager's website, a summary is provided in the UCITS' prospectus).
- The annual report of a UCITS must disclose the amount of remuneration paid by the UCITS manager for the financial year (split into fixed and variable), the number of beneficiaries and any amount paid out of the assets of the UCITS, including any performance fee.

REGULATORY SANCTIONS

New provisions to harmonise the regime for regulatory sanctions across Member States are also introduced by UCITS V. The principal provisions comprise:

- specification of instances where a regulatory sanction or action would be required;
- specification of the maximum permitted pecuniary sanction;
- requirements for sanctions to be published without undue delay and to include sufficient information regarding the breach as well as the identity of the person(s) responsible; and
- requirements for UCITS managers to implement whistle-blowing mechanisms.

STATUS UPDATE

The European Commission must adopt delegated acts setting out further provisions on a number of aspects of UCITS V. The content of the delegated acts will be based on technical advice issued by the European Securities and Markets Authority ("ESMA") pursuant to undertaking a consultation. To date, ESMA has issued technical advice for two delegated acts relating to the following aspects of the depositary function:

- the requirement for the protection of UCITS assets upon the insolvency of a sub-custodian - The advice proposes requirements to be met in respect of a delegation of safe-keeping to a sub-custodian, including

regarding the segregation of the UCITS assets from the delegate's own assets and due diligence to be undertaken by the depositary on the insolvency regime in the relevant jurisdiction; and

- the requirement for the UCITS manager and depositary to be independent - The advice identifies risks to the independence requirement and proposes requirements to ensure a depositary's independence is not jeopardised.

Regarding the remuneration requirements, ESMA is required to issue guidelines, in particular regarding the identification of personnel subject to the requirements and the application of the remuneration principles. ESMA launched a consultation of the proposed guidelines on 23 July 2015 which will close on 23 October 2015.

Regarding national implementation of UCITS V in the UK, the FCA has begun consulting on changes to its rules and regulations with the publication of consultation paper CP15/27 on 3 September 2015. For Luxembourg, the CSSF issued a Circular in July 2014 introducing rules affecting depositaries of UCITS - pre-empting UCITS V - which take effect on 31 December 2015. For Ireland, we are awaiting the publication of draft implementing measures by the Central Bank.

Next / preparatory steps

UCITS managers should be aware of and take note of the following matters:

- the depositary will wish to update the depositary agreement to reflect its duties as provided for under UCITS V. UCITS managers should ensure that the depositary is aware of all cash accounts opened for or otherwise associated with transactions of the UCITS, and ensure procedures prohibit the opening of such a cash account without the depositary's knowledge;
- for UCITS holding, or that may hold, "other assets" for the purposes of UCITS V (*i.e.*, assets other than financial instruments that may be registered or physically delivered to the depositary), agree with the depositary procedures to enable the depositary to verify ownership of such assets;
- UCITS managers should ensure the re-use of assets held in custody is only permitted in compliance with the UCITS V requirements;
- remuneration policies and practices may need to be created and/or updated together with consequential amendments to other policies and procedures. UCITS managers should consider the formation of a remuneration committee; and
- updates to prospectus documents, other fund materials and websites may be required as appropriate.

For advice on the impact of the UCITS V Directive, please contact your usual Investment Management contact at K&L Gates LLP.

Notes:

[1] Directive 2009/65/EC (as amended).

[2] Directive 2011/61/EU.

KEY CONTACTS



ANDREW J. MASSEY
PARTNER

LONDON
+44.20.7360.8233
ANDREW.MASSEY@KLGATES.COM



C. TODD GIBSON
PARTNER

BOSTON, PITTSBURGH
+1.617.261.3140
TODD.GIBSON@KLGATES.COM

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