

International Securities Services



UCITS V

International Securities Services Virtual Roundtable



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UCITS V is due to be transposed into national EU laws on March 18th 2016.

Ahead of this date, International Securities Services' *Matthew White, Paul Ellis (Head of Product Solutions – Regulatory Change at HSBC Securities Services), David O'Keeffe (CEO of SMT Trustees (Ireland) Ltd.), and Declan O'Sullivan (a Dublin based Partner of Dechert LLP)*, gathered together virtually to exchange thoughts on a range of issues arising from this latest iteration of the UCITS Directive.

Matthew White: Is it possible that UCITS V will be delayed beyond March 18th 2016?

Paul Ellis: UCITS V Level 1 provisions are due to come into effect on March 18th 2016, however the practical application of further detailed implementing measures is expected to be subject to some transitional arrangements. For example, the three-month scrutiny period by the European Parliament and Council of the European Commission's proposed UCITS V Level 2 implementing measures applicable to UCITS depositaries is due to complete on March 16th 2016. Once adopted, these measures are expected to apply in all EU member states six months after entry into force without the need for transposing legislation.

David O'Keeffe: The consensus is that there will be no delay as this date has been established in the directive and known for some time. However, depositary agreements that need to be in place before this date may have to be amended once the final details of the Level 2 provisions are issued by the Regulator. From a Depositary perspective, March 18th is a go live date for all aspects of the new obligations and responsibilities of a Depositary to a UCITS fund.

Declan O'Sullivan: No, UCITS V is coming into effect on March 18th and will apply from that date. While best efforts will be made, some aspects of UCITS V implementation may not make the deadline. For example, not all UCITS V depositary agreements will

have been finalised or fund prospectuses updated. However, for most this process is well in hand. ESMA guidance on remuneration is also awaited. Policies are currently, in the Irish industry, quite high level as we await ESMA's guidance on the topic.

Matthew White: What are the main similarities between preparing for AIFMD and UCITS V?

Paul Ellis: UCITS V mirrors two of the key pillars of investor protection required of AIFMD. Both focus on the obligations of the depositary and application of rules as to UCITS management company remuneration.

The depositary performs a key role for fund investors by providing high standards of investor protection across invested asset classes. Depositaries will have so called strict liability for financial instruments in custody such as listed equities and bonds. This means that if there is a problem with such assets being lost from segregated client accounts then the custodian has to replace them unless it can prove that the reason for loss was an "external event" beyond its control. Sub-custodians are not deemed "external" so this liability extends through the entire custody chain.

Investors will also be protected from inadvertent or deliberate actions that cause a loss of cash from the assets of investors. Depositaries must undertake a series of checks to detect any invalid

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client management and product development roles prior to and since joining HSBC Securities Services ("HSS") in 2003. Paul is Head of Product Solutions – Regulatory Change for HSBC Securities Services. He has global

business responsibility for developing and delivering product solutions driven by significant local, regional and global regulatory change impacting HSS and its customer groups.

cash flows during the day-to-day operations of the UCITS. Derivatives structured by way of contract cannot be held in custody and are therefore considered “other” assets. The protection of such assets for UCITS investors will be achieved by placing an obligation on the depositary to verify that such contracts exist.

UCITS V provides rules on the remuneration of UCITS management companies. Remuneration policies and procedures should be designed and implemented so as not to encourage excessive risk-taking and be linked to the long term interests of investors. ESMA’s consultation on the UCITS remuneration guidelines closed on October 23rd 2015, with final guidelines yet to be published.

David O’Keeffe: The similarities cover both the depositary requirement providing cash flow monitoring, safe keeping and oversight and the composition of a detailed remuneration policy. However, the depositary requirements for UCITS V do differ from AIFMD where there is no provision now for the discharge of liability to the sub-custodian who holds the assets of the fund.

Declan O’Sullivan: UCITS V has been more of a revising update than the game changer that AIFMD was. We also benefitted from the work that was done under AIFMD with regard to the principal changes dealing with depositaries and remuneration. Accordingly, the focus has been on trying to implement UCITS V with the least amount of fuss and disruption. The focus thus far has been on depositaries with the work product with regard to remuneration, particularly for its application to delegates, awaiting ESMA’s guidance.



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UCITS V is the natural extension to UCITS IV and provides the additional level of scrutiny by appointing an independent depositary who will have all the duties and obligations that the Alternative Investment Funds presently enjoy.

- David O’Keeffe,
SMT Trustees
(Ireland) Ltd.



Matthew White: Does the changing European landscape, including UCITS V, impact your view of the UCITS business?

Paul Ellis: UCITS V reinforces the gold standard demanded by international retail and institutional investors seeking a high quality fund product. At the end of 2015, UCITS assets under management were in excess of €8 trillion and it will be interesting to see whether the additional investor protection measures demanded by UCITS V will translate to investors differentiating UCITS compared to other investment opportunities. For their part, depositaries will have been carefully analysing the consequence of the transfer of risk from investors to depositaries. While it is unlikely we will see any of the main depositary players withdraw from the market, questions as to the continuity of investible markets and costs of UCITS V may be a concern for some managers.

HSBC leverages the breadth and strength of our in-house proprietary agent network to control and manage UCITS V risks. We are fully committed to our UCITS business and have sought to realise the strengths of our operating model for the benefit of our UCITS clients.

David O’Keeffe: UCITS V is the natural extension to UCITS IV and provides the additional level of scrutiny by appointing an independent depositary who will have all the duties and obligations that the Alternative Investment Funds presently enjoy. This can only benefit the UCITS structure and ultimately the investors enhancing the UCITS model to be a structure of choice for European distribution.

Declan O’Sullivan: UCITS remains an extremely strong brand with a strong pipeline particularly for Ireland’s new ICAV structure. Recent regulatory noises that no further UCITS changes are in the pipeline will create further certainty around the product. However, we are always in thrall to the vagaries of the markets.

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- Paul Ellis, HSBC ”

Matthew White: How will the new depositary laws affect custody arrangements? Will depositaries increase their prices as a result of UCITS V?

Paul Ellis: UCITS V depositary obligations, particularly when looked at in combination across all asset classes, do clearly change the conventional view of custody from being a largely

commoditised business to one where risks are transferred for the benefit of investors to depositaries. In particular, it is the so called strict liability for custodied assets which has been front of mind for depositaries preparing for UCITS V. Of course, assets are commonly dematerialised and once properly segregated are unlikely to be permanently lost.

However, the practical implications of a “black swan” type event for a UCITS V depositary may not be immediately obvious. Crucially the ability of a depositary to manage those risks, through for example its own proprietary network, and to have the financial strength to withstand adverse events is key to the long term interests of investors.

Such considerations are also relevant in assessing the price of UCITS V compliance as costs incurred by depositaries for providing this extra protection will undoubtedly increase. Depositaries capable of internalising some of those risks should be capable of mitigating some of the costs of compliance for promoters.

David O’Keeffe: The depositary arrangements will require new agreements incorporating the newly acquired responsibilities and obligations of a depositary. The depositary itself will also have an increased oversight of the service providers to the fund such as the investment manager, the administrator and naturally the sub-custodian and their network. This may also lead to amendments to the agreements between the depositary and the sub-custodian. Fees will inevitably be reviewed to account for the additional work required that may indeed vary depending on the investment policy of the fund, the markets invested in and the asset types traded.

Declan O’Sullivan: The changes have been well described by Paul and David. Prices have increased due mainly to the new cash monitoring requirement and the additional risk associates with markets being invested in e.g emerging markets.

Matthew White: How will fund documentation need to change as a result of UCITS V?

Paul Ellis: The management of changes to UCITS funds documentation is one of the significant practical consequences of UCITS V for promoters. It is likely that most promoters will be managing documentation and disclosure updates required across depositary agreements, fund prospectus, key investor information documents and fund financial statements. The ESMA Q&A on February 1st 2016 helpfully provides guidance on the practical transitional arrangements for making such updates to documentation.

David O’Keeffe: There will need to be new depositary agreements reflecting the requirements of UCITS V and likely also amendments to custody agreements and fund offering documentation. In addition, each investment manager will need to have a remuneration policy in place before the end of the financial year for each UCITS fund they manage.

Declan O’Sullivan: Prospectuses need to be amended with remuneration language and the terms of the new depositary contracts. Helpfully, ESMA confirmed that the KIID did not need to be updated for March 18th, as that would have been extra cost right after the February annual update. New remuneration and whistleblowing policies also have to be put in place.

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David O'Keeffe is CEO of SMT Trustees (Ireland) Ltd, a subsidiary of SuMi TRUST, which provides the Trustee, Custodian and Depository services to Irish and, through a wholly owned Cayman subsidiary, funds domiciled there. He has been with SuMi TRUST (formerly

the Daiwa Securities Group) since 1999, having worked in various roles in fund administration including Head of Shareholder Services, Head of Risk and Head of the Internal Audit function, amongst other roles. Prior to this he worked for a number of years in

the fund administration subsidiary of Dresdner Bank AG, Dresdner Bank (Ireland) plc, and also for Rudolf Wolff Fund Management Limited, including the position of Director for a CTA futures trading program subsidiary company.

Matthew White: What will UCITS V mean for the availability of independent directors? How will the costs, rates, responsibilities and involvement of any directors change as a result of UCITS V?

Paul Ellis: UCITS V contemplates the need for independent directors where the management company and depository are linked via a group structure or through a qualifying shareholding. The European Commission's proposed Level 2 text states that to deepen the independence of the relevant entities which belong to the same group, at least one-third of the members or two persons, whichever is the lower, of the respective management bodies shall be independent. In practice, such persons shall be deemed independent as long as they are neither members of the

management body nor employees of the undertakings between which a group link exists. They should further be free of any business, family or other relationship with the management company, the depository and any other undertaking within the group that gives rise to a conflict of interest such as to impair their judgment.

The application of this requirement by UCITS is unlikely in its own right to impact the availability of independent directors. There will however be some incremental costs for firms whom need to appoint additional independent directors.

David O'Keeffe: Independent directors are already required and it will be important to establish that the independent directors have a detailed understanding of the new UCITS V environment to fulfil their responsibilities and obligations. It is not expected that independent directors' fees will increase and, given the introduction in 2014 of similar roles and responsibilities for the Depository for alternative investment funds, Directors acting for such funds will bring a wealth of understanding to the UCITS product.

Declan O'Sullivan: We have not seen any changes in costs or involvement for directors under UCITS V. Larger changes are resulting from the Central Bank's CP 86 process which focuses on Management Company oversight and delegation and has overhauled the UCITS management company functions in Ireland.

Matthew White: How will UCITS V affect remuneration policies? Will different remuneration policies apply for asset managers based in different jurisdictions?

Paul Ellis: ESMA's consultation on the UCITS remuneration guidelines closed on October 23rd 2015 with final guidelines yet to be published. It will be important for UCITS to analyse those guidelines and the consultations on remuneration also provided by member state regulators.

The Level 1 text and ESMA consultation provides much detail on what management companies can expect. For example, management companies are expected to establish and apply remuneration policies and practices that are consistent with, and promote, sound and effective risk management. The practical application of these policies should neither encourage risk-taking that is inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS they manage, nor impair compliance with their duty to act in the best interest of the UCITS.



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Declan O'Sullivan
 Partner
 Dechert LLP

Declan O'Sullivan is a Dublin-based partner at Dechert LLP who advises domestic and international clients in the establishment and authorisation of all types of investment funds including UCITS, hedge funds, property funds and

private equity funds. Declan O'Sullivan also represents many leading fund service providers in Ireland, including investment managers, administrators and custodians.

A key consideration for UCITS management companies preparing to implement UCITS V remuneration policies is the extent to which the final rules will be proportionate to their business and the Level 1 text and ESMA consultation seeks to address the matter.

The Level 1 text states that the policies and practices must be proportionate to the size of the management company, the size of the UCITS they manage, their internal organisation, and the nature, scope and complexity of their activities.

The application of the principle of proportionality will also be an important consideration for European or third country investment advisers appointed by the UCITS.

David O'Keeffe: The remuneration policy will be the responsibility of the local regulator who may apply different tests to determine the remuneration guidelines and to what extent they will follow proportionality in terms of the UCITS AUM, the size of the investment manager, the distribution policy, investment strategy and risk policy.

Declan O'Sullivan: For managers who are AIFMs or regulated under MiFID in Europe, the changes will be minimal as the remuneration requirements already apply to them. The major impact will be the extent the ESMA guidelines will seek to apply the remuneration provisions to delegates in different jurisdictions. This was a hot topic under AIFMD and will continue to be under UCITS. We would hope to see any application to delegates applied

in a sensible and proportionate manner that will not impact on managers, particularly US managers, availing of UCITS structures for global distribution.

Matthew White: A new sanctions regime will apply to breaches of the main investor protection safeguards in the UCITS Directive. What practical impact will this have as far as whistle blowing is concerned?

David O'Keeffe: Sanctions regimes are already in place in many jurisdictions with whistle blowing understood and practiced. Where a sanctions policy is not already documented and active then this will be required.

Declan O'Sullivan: In Ireland, whistle blowing legislation has been enacted for a number of years. The funds industry in Ireland is highly regulated and highly compliant. As a result, it is not expected that the whistle blowing requirements will have any significant operational impact but, for investors, they are an important additional safeguard.

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Matthew White
 Publisher
 International Securities Services

Matthew White has been Publisher of International Securities Services since February 1st 2016. He is tasked with coming up with new ideas for virtual roundtables, and attracting sponsorship to support them.

Prior to International Securities Services,

Matthew had three year stints as Publisher of Global Custodian magazine and Commercial Director of Infrastructure Investor magazine.

For nine years he held a contract with Euromoney Institutional Investor PLC - where he developed ideas for new publications

and supplements for Euromoney Yearbooks, Corporate Finance magazine and Institutional Investor News – and ran sales teams working on these projects.

During his career, Matthew has written editorial synopses for more than 50 commercially viable projects.