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Are you ready for UCITS V?

The UCITS V directive comes into effect on 18 March 2016. It brings with it the possibility of more expensive depositary services, tighter regulation of remuneration, and a code of sanctions to enforce compliance. Depositary banks have declared themselves ready. So what do managers need to do now to ensure they too are ready for UCITS V?

It is easy to be complacent about UCITS V. It is the fifth iteration of a European Union (EU) regulatory regime that now dates back over 30 years. The principal changes introduced by the new measure cover the services provided by the depositary, which is a service provider that every UCITS fund has in place already. Much of the rest concerns remuneration restrictions, which many fund managers believe will not apply to them on grounds they would be disproportionate to their size.

Such complacency is a mistake. UCITS V will require extensive re-writing of the contracts which fund managers have with their depositary banks. Fund managers may be familiar with remuneration rules via the Alternative Investment Fund Managers Directive (AIFMD) and – if they are controlled by a bank – the fourth Capital Requirements Directive (CRD IV), however, UCITS V still necessitates the composition of a detailed remuneration policy.

Above all, the timetable is now extremely short, and detail is lacking. UCITS V comes into effect on 18 March 2016, but fund managers presently have clear guidance on the so-called Level I measures - the Directive itself, which outlines the objectives of the legislation in broad terms – only. The Level II measures, which turn the broad requirements outlined in Level I into regulations market participants can follow, are unlikely to be agreed and published before September 2016.

In other words, fund managers will from 18 March be obliged to comply with a directive, many of whose detailed provisions remain unknown. UCITS V aims not only to end the absurdity of institutional investors in alternative funds being better protected under AIFMD than retail investors in mutual funds under UCITS, but to harmonise 28 member-states of the EU in three areas: depositary responsibilities, remuneration restrictions, and sanctions and whistleblowing.

Depositary

The first and most important of these harmonisation goals is depositary services. Compliance will not be easy. The lack of Level II measures means that fund managers are from 18 March under an obligation to appoint a UCITS V-compliant depositary, but in the absence of sufficient detail to draw up a contract specifying the duties of the depositary. In fact, the Commission de Surveillance du Secteur Financier (CSSF), the Luxembourg regulator, has had to postpone distribution of a circular on its own depositary rules because of the absence of Level II measures.

Fortunately, depositary banks argue that they are ready for the 18 March deadline, because they have already developed services to fulfil the obligations of a depositary under AIFMD in 2014. They are now sharing draft contracts with buy-side clients, confident that the AIFMD experience is helpful. The eligibility criteria for a UCITS V depositary are certainly the same as for an AIFMD-compliant depositary. In other words, it has to be a national bank or a CRD IV-authorised credit institution, or another legal entity that can meet minimum capital requirements.

The depositary must also have a registered office in the home state of the UCITS funds whose assets it safekeeps. Importantly, this means there is no depositary passport, in the sense that an EU depositary appointed in one jurisdiction can serve for every EU jurisdiction. This restriction reflects the anxiety of regulators that smaller depositaries unable to assume the increased liabilities imposed by UCITS V will have to exit the business, leading to a systemically worrying concentration of business with a small group of large custodian banks.

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The core functions of the depositary also match those of the AIFMD. But there the similarities end. Indeed, raising UCITS depositaries to the level of responsibility of an AIFMD depositary represents a major increase in liabilities by comparison with UCITS IV. Under UCITS IV, the depositary had merely to check the fund was in compliance with the prospectus.

A UCITS depositary must now monitor cash flows into and out of the fund on a daily basis; safekeep and service the assets of the fund; segregate assets at every level in the asset-holding chain; and will not be allowed to re-use assets held in custody for their own account. The re-use on behalf of the UCITS will remain possible upon direct instruction of the management company, in the interests of unitholders, e.g. stock lending, and provided that transactions are covered by high quality liquid collateral. The depositary must also be chosen carefully – there is a strict due diligence procedure that managers must follow in appointing a depositary – and checked for independence from the management company and the fund, and for freedom from conflicts of interest.

Much of the detail of how the relationship between the manager and the depositary will work in practice awaits publication of the Level II measures in September 2016. But the draft measures published on 18 December 2015 lay down minimum contractual requirements; specify the duties and obligations of the depositary; and outline the oversight and control functions of the depositary, including escalation procedures, how assets held by sub-custodians must be segregated, the allocation of liability for investor losses between the depositary and its sub-custodians, and how investor assets will be protected in a case of insolvency.

None of this will be easy to write into a depositary contract prior to the publication of the final Level II measures. Managers running AIFs already have experience they can draw upon, but in terms of liability UCITS V goes beyond AIFMD. In most circumstances, UCITS depositaries now face strict liability for loss of financial instruments belonging to investors.

Importantly, the liability includes assets whose safekeeping the depositary has delegated to third parties. Unlike the AIFMD, those third parties include the central securities depositaries (CSDs) that custodian banks are obliged to use to hold assets and settle transactions in every market where funds are likely to invest. Nor can liability for losses be discharged to delegates in the same way as it can under AIFMD.

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Managers are advised to talk to depositary banks now to ensure the assets they hold will still be covered, and at what price. After all, depositaries are extremely unlikely to accept any liability beyond what the UCITS V directive specifies. Managers will have to press their depositaries to obtain complete clarity on the extent of the liability of the depositary for different classes of asset, depending on how and where they are held.

Some will be reluctant to do this, for fear of sparking an increase in the price of depositary services. But managers should resist the temptation to underestimate the importance of striking the right balance between the cost of a depositary and the liabilities it assumes. After all, a higher level of liability for a depositary ought to reassure managers and their investors. In addition, the difficulties of working with a depositary under the AIFMD were not as onerous as anticipated, and the increase in custody fees was more modest than expected as well.

As UCITS V is implemented, managers are now also operating in a market in which a much larger number of firms are seeking depositary services, and clarity on their terms of business, in an environment in which the Level II measures are not yet finalised. Managers need to understand the likely contents of a revised depositary contract, and how UCITS V will affect the documentation of the fund itself. In fact, one reason it is important fund managers understand what the additional cost of appointing a UCITS V depositary is likely to be is the fact that this will have to be disclosed in the updated prospectus of the fund.

Remuneration

The second of the three harmonisation goals of UCITS V is remuneration restrictions. These are imposed on management companies, delegates of management companies, and independent or self-managed funds run on behalf of UCITS clients. Since they apply to delegates as well, for non-European managers running money on behalf of UCITS funds as a delegate, the remuneration requirements are now inescapable.

As with the depositary requirements, the remuneration rules are broadly comparable with AIFMD. In common with the effect of that measure on the alternative investment management industry, UCITS V extends to the European mutual fund management industry remuneration controls of the kind already applied to the banking industry via the fourth Capital Requirements Directive (CRD IV).

They also come into effect on 18 March, and apply to the first remuneration cycle thereafter. In other words, a manager operating to a calendar year will effectively have to apply the rules from 1 January 2017. A manager whose remuneration cycle starts on 1 April, by contrast, will have to apply the rules more or less immediately.

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That will not be easy, because final guidelines on remuneration have yet to be published by the European Securities and Markets Authority (ESMA). They are due at some point in the first quarter of 2016. Until then, the current draft of the remuneration guidelines, which was used as the basis of the consultation conducted by ESMA between 23 July and 23 October 2015, gives the clearest indication of what is required.

Managers caught by UCITS V will have to ensure they have put in place a remuneration policy setting out how various categories of staff are remunerated. It should cover salaries, bonuses, discretionary pension benefits, performance fees and the allocation of units in the fund. This has obviously to be explained to the staff affected, who are categorised under UCITS V article 14a (3) as anyone whose activities have a material impact on the risk profile of the management company or UCITS fund.

The draft guidelines from ESMA suggest heads of administration, marketing and human resources as well as portfolio managers will be caught by the remuneration provisions. So indeed are other “risk takers,” a category which includes anyone who exerts “material influence” over the risk profile of the management company or the fund, or who is simply a high earner.

In fact, to ensure they comply, management companies and self-managed funds will have to analyse all job functions and responsibilities within their organisation, and ratify with employment lawyers and consultants that their remuneration policy meets the regulatory demands of UCITS V in full.

In the United Kingdom, the guidance issued to managers by the Financial Conduct Authority (FCA) on the application of the AIFMD remuneration rules - which is being followed closely by regulators in Ireland and Luxembourg - is proving helpful in this process.

The AIFMD rules issued by the FCA have already changed how AIFs pay high earners, in terms of deferral of compensation, retention of earnings and payment in units of the fund. Though the FCA says its AIFMD rules can be applied in a fashion that is "proportional" to the size of the fund and payments proposed, and many managers are counting on the same relief to be extended to UCITS funds, but there is still no exemption from the requirement to have a remuneration policy.

An added degree of complexity stems from the fact that each major fund jurisdiction will create its own variant of the UCITS V remuneration rules regime, using the UCITS V requirements as a foundation only. Importantly, although remuneration policies do not have to be submitted to regulators in any jurisdiction by established funds, they are likely to become a component of the approval process for new funds.

This matters greatly, because it is likely to influence the choice of European domicile made by standalone managers in particular. This is likely to be especially true of the initial UCITS V implementation period, before a degree of homogenisation develops across the EU. When the AIFMD came into effect, for example, Malta sought a competitive advantage by electing not to apply the remuneration rules of the directive to delegates.

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That had less impact than Malta hoped, but regulatory arbitrage is nevertheless a strong possibility under UCITS V. Shopping for a more amenable jurisdiction would be an ironic consequence of a directive whose purpose is to create a single regulatory regime for mutual funds in Europe, especially in terms of depositary functions, but it is not an option open to larger fund complexes distributing funds in multiple jurisdictions anyway.

They will instead have to develop either separate remuneration policies, or a single remuneration policy that covers all jurisdictions. This is especially the case in Luxembourg, where managers of locally domiciled funds are managed from virtually every jurisdiction in Europe, and will have to comply not only with the Luxembourg regime but that of their home country as well, though the Grand Duchy has fewer highly paid fund managers than, say, London.

Whether they are in London or not, some of the managers affected by the UCITS V remuneration regime will be managing AIFs as well as UCITS. They will as a result have to comply with the AIFMD as well as the UCITS V remuneration regimes. Any manager owned by a bank has the further complication of having to consider the CRD IV rules too.

That said managers compliant with the AIFMD or CRD IV remuneration rules will also enjoy the advantage of being able to assure clients that their firm is compliant already, on grounds that it complies with an equivalent regime already. Indeed, ESMA has stated that compliance with the CRD IV or AIFMD rules is equivalent to compliance with the UCITS V rules.

Although ESMA has invited non-EU managers to demonstrate how other remuneration regimes might also match the UCITS V rules, ultimately few managers based outside Europe will be able to rely on “equivalence” to escape the remuneration provisions of the directive. They will have to re-write contracts with their UCITS clients to include a commitment to comply with the remuneration rules.

This is a particularly unwelcome development for fund managers based in the United States, which are not required by the Securities and Exchange Commission (SEC) to have any remuneration policy at all. However, experience with the AIFMD suggests managers are able to adapt their remuneration practices with less difficulty than they had originally anticipated.

Sanctions

The third of the three harmonisation goals of UCITS V is the least noticed: the harmonisation of sanctions regimes throughout the EU, and the introduction of a whistleblowing regime. It reflects an ambition to replace the piecemeal nature of sanctions regimes in the EU today. Prior to UCITS V, the disciplines imposed on UCITS managers for breaches of regulation were entirely arbitrary, with alleged offences attracting sanctions in some EU member-states but not others.

UCITS introduces instead a (non-exhaustive) list of 19 specific breaches. They include carrying on an investment management business without prior authorisation; obtaining authorisation through false statements or other irregular means; failure to comply with investor information requirements; and failure to comply with national rules of conduct.

National regulators are obliged by UCITS V to report breaches to ESMA, and publish details of them, and the people responsible, on their web sites (though they are also permitted to publish details anonymously). The same obligations, interestingly, are laid on depositaries – so banks might also incur fines for breaches of regulations.

Firms of any kind guilty of breaches will face three different types of sanction. The first is an order to cease and desist from the non-compliant conduct. The second is the suspension, or withdrawal, of regulatory authorisation to continue in business. The third is pecuniary sanctions, up to a maximum of the higher of €5 million or 10 per cent of the total annual turnover of the firm. This is in line with global trends, where regulators increasingly look to fund their activities through fines.

> "Managers need to understand the likely contents of a revised depositary contract, and how UCITS V will affect the documentation."

It is probably unnecessary for managers to re-write fund documentation to take account of the new measures. But it would be prudent for directors of UCITS management companies or self-managed funds run on behalf of UCITS clients – where any pecuniary sanctions would fall directly on the investors, as opposed to the managers - to ensure they know what is on the list of 19 breaches and understand the risks of non-compliance.

Under UCITS V, they are also expected to put in place “effective and reliable mechanisms” to encourage whistleblowers to report actual or potential infringements. That means providing “independent and autonomous communications channels” and guaranteeing confidentiality to whistleblowers, at least up to the point where regulatory or judicial proceedings begin.

While whistleblowing is familiar in Anglo-Saxon business culture, the extension of the practice under UCITS V will be a novel experience for many European managers. Although Luxembourg has levied fines for some years, they were never punitive. Ireland, on the other hand, introduced whistle-blowing legislation in 2015, and it has introduced UCITS V as a statutory instrument, which makes it easier for the regulator to impose fines for breaches of regulations.

Conclusion

Many fund managers have considered delaying launching funds in Europe until the UCITS V regime is established. This is because one effect of UCITS V, in bringing the regulation of UCITS funds into closer alignment with AIFs, is to make the decision on which vehicle to adopt finely balanced.

Managers looking to distribute funds in Europe will choose an AIF (which is regulated under AIFMD) over a UCITS (which is regulated under UCITS V) if their target investors are wholesale rather than retail, and their strategy makes use of asset classes and investment techniques that regulators prefer to confine to sophisticated audiences.

Complex managers will obviously make use of both AIFs and UCITS, and will also make judgments based on which vehicle is most popular in non-EU countries such as Taiwan, Singapore, Hong Kong and Latin America, where UCITS funds have established a considerable following as regulated vehicles. But managers need also to be mindful of the likely evolution of both the UCITS and AIF regimes.

AIFs based in Europe have in place already a distribution passport – the right to sell a fund regulated in one EU jurisdiction to any type of investor in any other EU jurisdiction – but so far ESMA has indicated that only AIFs based in Jersey, Guernsey and Switzerland will enjoy the same privilege. Clearly, AIFS based in the Cayman Islands, and currently using the private placement regime, cannot count on gaining access to the passport.

For some managers, and especially those based outside the EU, this uncertainty will argue for adopting a UCITS fund structure. In fact, non-EU managers already compliant with AIFMD will find adaptation to the UCITS V regime relatively straightforward. Though there is some urgency attached to re-writing depositary agreements, it is the remuneration rules that will present more challenges to managers in general and non-EU managers in particular - though even those will be familiar to some from their AIFMD experience.

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