UCITS V: what fund managers need to do differently

The fifth iteration of the Undertakings for Collective Investment in Transferable Securities Directive (UCITS V) is a modest measure. Though it seeks to enhance investor protection, its measures add to the rules specified in UCITS IV rather than replacing or intensifying them. Its impact on fund managers and their propensity to launch UCITS funds, with the support of their fund administrators and custodian banks, will be commensurately light.

UCITS V is unlikely to dent the steady growth of the overall UCITS market, where the value of assets under management measured by the European Fund and Asset Management Association (EFAMA) has more than doubled in the last four years from €5,921 billion in February 2011 to €12,251 billion at the end of February this year.

Intriguingly, the alternative UCITS fund market is also growing. It has not expanded as fast as the UCITS market as a whole in the last four years, but has grown slightly faster since the bottom of the financial crisis in 2007-09. According to HFR, over the seven years since 2008 the value of the assets under management in alternative UCITs funds has increase four and a half-fold, from €40.86 billion to €187.73 billion. That is not large, in the context of a global hedge fund industry managing €2½ trillion, but it does mean the alternative UCITS industry is growing at a healthy compound annual rate of 21 per cent.

It is not hard to see why. Unlike alternative funds regulated under the Alternative Investment Fund Managers Directive (AIFMD), UCITS funds enjoy the use of an unconstrained and well-tested pan-European passport: a UCITS fund regulated in any European Union (EU) member-state can be sold in any other EU member-state. Institutional investors already denied access to alternative managers and strategies they favour by the reluctance of non-European managers to distribute under the AIFMD are more open than ever to purchasing them in a UCITS wrapper instead.

After all, argue institutional investors, UCITS funds offer a higher degree of trustworthiness, liquidity and transparency without being regulated in a noticeably more cumbersome or expensive manner than traditional hedge funds under AIFMD. Encouraging this attitude is in fact part of the intention of UCITS V. The directive aims, among other goals, to end the regulatory absurdity of giving a higher degree of protection to sophisticated investors in hedge funds under AIFMD than to the predominantly retail investors in UCITS funds.

UCITS VI, which has yet to advance beyond the consultation paper published in July 2013, is expected to take that logic a step further and discourage the use of UCITS funds to expose retail investors to sophisticated alternative investment strategies in general, and derivatives in particular. Instead, European regulators would prefer these strategies and instruments to be restricted to funds regulated under the AIFMD. UCITS managers facing competition from alternative vehicles, especially in Asia, are concerned by this. They contend that, although they can and do use swaps to expand their exposures, the range of investment strategies that UCITS funds can accommodate is already narrow.

The facts support that assertion. According to the HFR data, alternative UCITS funds investment strategies are generally restricted to equity long/short, macro, relative value and event-driven. In fact, the proportion of alternative UCITS funds pursuing an equity long/short strategy is more than twice (61.3 per cent) that of the hedge fund industry as a whole (27.9 per cent). This reflects the fact that UCITS funds are subject to limits on their exposure to any one sector, constraints on the use of both derivative instruments and leverage, and demand much higher levels of liquidity than orthodox hedge funds. In offering access to a wider range of strategies and asset classes, AIFs are already more attractive than UCITS.

So whether managers like it or not, the European regulatory system is succeeding in its aim of dividing the European funds markets between retail funds regulated under UCITS and alternative funds regulated under AIFMD. Although the alignment of the UCITS and AIFMD regulatory regimes is one of the principal goals of UCUTS V, the practical effect is to bifurcate the alternative fund markets of Europe between retail and non-retail. Details of the technical requirements to implement UCITS V are expected to be published by the European Securities and Markets Authority (ESMA)

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in August this year. This means the local implementations of UCITS V - especially in Ireland and Luxembourg, which between them dominate the domiciliation and administration of UCITS funds - are unlikely before the end of this year.

It will not be much later because the UCITS V directive is scheduled to become law throughout the European Union (EU) by March 2016. So although the scope of UCITS V is relatively limited and largely additional to existing UCITS rules rather than a substitution for them, there will be little time for managers to consider how to react to the new measures before member-states bring them into effect. Between now and then, managers will have to ensure they comply with all the new requirements, and update their prospectuses to reflect that. That is not a trivial task, but many managers will already be compliant with the same or similar measures under the AIFMD, so the adaptation should not be unduly onerous.

Chief among the new rules is the obligation to appoint to each UCITS fund a depositary with the same duties as its counterpart in the AIFMD, but with a wider range of types of institution available under UCITS V than was the case with AIFMD. Those duties are to safekeep and segregate client assets, monitor valuations of the assets and cash flows into and out of the fund, and to ensure the management complies with the terms of the fund prospectus. Fears that UCITS depositaries that were part of the same corporate group as the fund manager would be forbidden proved unfounded, provided the depositary is sufficiently independent and any conflicts of interest - such as providing prime brokerage and fund administration services to the fund – are managed and disclosed to investors in the fund.

But there are some material differences between the obligations imposed on UCITS and AIFMD depositaries. Although AIFs as well as UCITS must disclose any delegation of safekeeping duties, including the list of sub-custodians used, UCITS V specifically requires of UCITS managers that the disclosure be made in the prospectus. This forces UCITS managers to update the prospectus every time they change a depositary or a transfer agent. More importantly, while AIFMD depositaries can discharge their liability for loss of financial instruments held in custody where they can find an "objective reason" for doing so, this delegation option is not open to UCITS V depositaries, which can escape liability only where the loss is "external," "beyond reasonable control" and "unavoidable," and not by passing it to a third party.

A loss which is "external," "beyond reasonable control" and "unavoidable" – the language is common to both AIFMD and UCITS V - is a stern test, clearly covering assets held by all kinds of sub-custodian and central securities depository (CSD). It includes assets forfeited through fraud, insolvency, operational failures and inadequate segregation. Unlike AIFMD depositaries, UCITS V depositaries cannot discharge their liability to a third party by means of contract either. UCITS V depositaries are also faced with a liability which extends beyond sub-custodians to the market infrastructure. They take responsibility for losses at the CSD, whereas it halts at the sub-custodian under AIFMD. While even UCITS V depositaries are relieved of responsibility for loss of financial assets not held in custody - such as private equity investments, where they have only to verify ownership and maintain up-to-date records - this increased liability will have consequences.

As the AIFMD experience proved, increased liability for loss of client assets forces depositaries to review (and re-review regularly) every sub-custodian, transfer agent and CSD that has any responsibility for holding client assets. Depositaries are already re-writing their sub-custodian due diligence questionnaires to take account of the UCITS V rules. This heightened sense of risk is unlikely to increase the cost to investors of buying depositary services in the major markets, where there are plenty of creditworthy banks and intense competition for the business. However, the price of depositary services in emerging markets is likely to increase, generating costs that diminish investment returns.

That said, strict liability will probably have its largest impact on fund performance in another way. If they are to take on an unrewarded liability, depositaries will seek to prevent managers of UCITS funds investing in any jurisdiction where adequate safekeeping arrangements cannot be made. This is almost certain to reduce returns because riskier markets invariably offer higher returns. Depositaries will be obliged to disappoint fund managers because the additional risk has to be disclosed to investors, and the depositary also has to prove that, in the event of loss, it took all reasonable steps to mitigate the risk. Since that risk is by definition uncontrollable, depositaries will elect not to take it.

Depositaries have learned, from real experience in Iceland in 2008 and from their preparations for a default in Greece since 2010, that they will be judged by buy-side clients on what they fail to do as well as what they choose to do. That experience argues for giving fund managers as much information in advance as possible, and for taking steps to protect client cash in particular from getting trapped or lost. It is not reassuring to depositaries that UCITS investors are also empowered to make claims directly against depositaries, while AIFMD investors are not.

Depositaries face the additional anxiety that, if the assets of a UCITS V fund are lent or pledged as collateral, the transactions are always in the interests of the fund; never undertaken without the permission of the fund; and that any collateral taken in return is of the highest quality and sufficiently liquid and valuable to cover the risk of loss. Any assets lent or re-used remain the liability of the depositary. In this context, the concern on the part of depositaries - as yet unresolved – that the assets of a fund cannot be re-used except by means of title transfer is understandable. Title transfer has no effect on the lending of the securities, where title is always transferred, but it may well undermine the willingness of depositaries to support the pledging of assets as collateral.

Yet even a more cautious (and potentially costly) approach to risk by depositary banks is unlikely to deter managers from launching UCITS funds. A larger threat to their enthusiasm for UCITS funds stems from another aspect of UCITS V: the obligation it lays on fund managers to establish (and disclose in their annual reports) remuneration policies that promote the sound management of the risks incurred by the fund. In short, European regulators want to discourage firms from giving individual fund managers performance rewards – what the directive refers to as “variable remuneration” - that encourage them to take excessive risks in pursuit of higher personal rewards.

UCITS V prescribes detailed rules designed to achieve this. First, any individual manager running more than half the value of a portfolio must take at least 50 per cent of his or her variable remuneration in the form of units in the UCITS funds or its economic equivalent. Secondly, at least 40 per cent of that variable remuneration - the percentage is raised to 60 per cent in the case of exceptionally generous bonuses - must be deferred over a period in line with “the holding period recommended to investors,” which cannot be less than three years. Thirdly, variable remuneration must be governed by the overall financial performance of the fund and, when it falters, the rewards must be reduced by pre-vesting or clawback.

Naturally, managers of UCITS funds take the view that, as managers of highly regulated funds mostly created and distributed by large commercial organizations, it is difficult for any one individual to have a major influence over the risk profile of a fund. In fact, working out exactly which individual members of staff are captured by the remuneration provisions is one of the major challenges set for managers by UCITS V. The text of the Directive is broad in scope, referring to "any employee and any other member of staff at fund or sub-fund level who are decision- takers, fund managers and persons who take real investment decisions, persons who have the power to exercise influence on such employees or members of staff, including investment ad-

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visors and analysts."

The final technicalities of the remuneration rules are yet to be published by ESMA. The proportionality principle will apply in the sense that ESMA is obliged – as it is under AIFMD – to propose guidelines that take account of the size and internal organisation of the firm and the nature, scope and complexity of its activities. However, the task is complicated by the fact that UCITS V is only one of several European regulations that seek to shape the remuneration of fund managers. Fund managers are also affected by the fourth version of the Capital Requirements Directive (CRD IV) and the second iteration of the Markets in Financial Instruments Directive (MiFID II) as well as AIFMD. ESMA is now working with the European Banking Authority (EBA) to harmonise and integrate the remuneration provisions of these various measures.

While recognition that fund managers are subject to overlapping remuneration requirements is welcome, the final technical advice from ESMA is still awaited. The verdict is expected by the end of this year. Expectations of UCITS managers that ESMA will adopt a more forgiving approach to highly regulated funds may not be fulfilled. In fact, if ESMA applies the remuneration principles to UCITS funds in their strictest sense, all the controls managers have put in place to prevent individual members of staff having an excessive influence over the risk profile of a fund will count for nothing.

Strict application of the remuneration provisions will almost certainly deter some managers from launching a UCITS fund at all. A further risk is that it remains unclear to what extent the remuneration principles apply to managers based outside the EU, and to which a fund has delegated the management of some of its assets. The directive says remuneration rules apply in a proportionate manner to managers which run assets of a fund on a delegated basis, if they impact on the risk profile of the fund. This offers ESMA some room for manoeuvre – a third party manager responsible for a twentieth of the assets under management, for example, might reasonably be expected not to be subject to the full rigour of the rules - but, if the regulator chooses to apply the rules with excessive zeal, this will discourage talented managers based outside Europe from getting involved with UCITS funds.

One final reason to be cautious about the long term impact of UCITS V is its provisions on sanctions for breaches of UCITS rules. Following a European Commission study of 2010, which found enormous divergences in the sanctions available to regulators in different member-states of the EU where breaches of UCITS rules were identified, UCITS V aims to harmonise the penalties miscreants face. Breaches such as investing in asset classes forbidden by the prospectus, or altering an investment strategy without rewriting the prospectus, will in future be subject to a consistent set of penalties that are designed to be “effective, proportionate and dissuasive.”

This regime will not come into effect immediately. For now, member-states will retain the flexibility to fit any harmonised regime into their own administrative, judicial and criminal law regimes. However, all breaches at the national level will be reported to ESMA, which will publish the information in its annual report, with the goal of monitoring and encouraging progress towards a harmonised sanctions regime. ESMA will also set up a pan-European system for “whistle-blowers” to report breaches of the UCITS rules at the national level.

But UCITS V does also contain concrete and immediate proposals on sanctions. Plans to name and shame individuals responsible for breaches, in which the person would be identified by name alongside a description of the offence and a temporary or permanent ban from the industry, did not make the final text, but can still be used by national regulators in extreme cases. Individuals remain subject to a maximum fine of €5 million, and companies to the higher of €5 million or 10 per cent of annual turnover. These sanctions are severe enough for managers to treat any breaches reported to them by their depositary bank extremely seriously. UCITS V may be a modest measure, but fund managers should not treat its provisions lightly.

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