

**UCITS V -
Motivation and Scope**
Regulatory Update
March 2015

This white paper reviews the drivers behind the recently introduced UCITS V directive and the practical effects of some of its key updates

Introduction

The Undertakings for Collective Investment in Transferable Securities (UCITS) is a set of directives that were first adopted in 1985 with the aim of allowing qualifying investment funds to be sold across the European Union on the basis of an authorisation from a single member state.

The hope behind the legislation was that it would provide a more open and competitive market for asset management services, a homogeneous regulatory framework, and clarification of legal and tax aspects for investors within the EU. (It is not a regulatory requirement for investment funds to be UCITS compliant but, from a marketing and administrative point of view, the advantages are obvious).

The UCITS legislation has since been updated several times and the current version - UCITS IV – is soon to be replaced by UCITS V. Following its publication in the Official Journal on August 28th 2014, see [UCITSV], the fifth update of UCITS came into force on September 17th 2014, with 18 months to be transposed into national law. The new UCITS V rules will therefore apply from March 18th 2016.

UCITS V Motivation

The updates have been motivated by recent failures in the financial universe, such as Madoff's \$65bn Ponzi scheme, lessons from the collapse of Lehman Brothers, and the insider trading scandal at SAC Capital.

Several of the EU-based so-called feeder funds to Madoff's main fund did in fact carry the UCITS label and arguably violated several of the conditions for being UCITS compliant. One can observe from this that it's one thing to have rules drawn up and another for them to be followed or have auditors in place who can spot potential breaches. As an example, the marketing materials for these funds claimed that assets would be managed and held in custody by major European financial institutions. However, in reality, it was Madoff who managed and had custody of the assets. (Needless to say, Madoff's management company wasn't UCITS compliant).

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In the case of Lehman Brothers, UCITS compliant funds suffered losses from derivative positions where Lehman Brothers was the counterparty. Undoubtedly, it was a surprise to many investors in these funds to learn that, beyond market risk, they also had exposure to counterparty credit risk via derivative positions. While this risk is almost impossible to avoid in practice, regulatory initiatives such as the introduction of centralised counterparties under EMIR, and a stricter depositary regime under UCITS V both aim to improve investor protection against counterparty credit risk.

In the aftermath of the Lehman default, it further became clear that client money and collateral posted to the prime broker division had not been properly segregated, see [ASH], and that hypothecated collateral could not be recovered in a timely fashion. This obviously created a very complex legal situation, a repeat of which UCITS V seeks to avoid by imposing stricter rules on the depositary with respect to cash and collateral management and securities financing in general.

By its own nature, insider trading is very hard to spot and the insider trading scandal at SAC highlighted the seriousness of the problem. Building a solid case and successfully prosecuting violators is difficult and a recent federal court decision has further complicated matters by raising the bar for what prosecutors must prove, see [BLB]. Under UCITS V, regulators try to lend a helping hand to solve these problems by requiring that member states introduce protection programs for whistle-blowers.

Whereas UCITS was primarily aimed at the traditional long-only asset management industry, the latest update further attempts to align UCITS with the Alternative Investment Fund Managers Directive (AIFMD). By harmonising regulations with the European hedge fund and private equity sector, UCITS is moving to streamline regulation over the entire spectrum of funds within the EU. See [AIFMD] for details.

UCITS V Scope

From a high level UCITS V introduces regulation in three areas:

- A new depositary regime
- New Rules governing remuneration policies of UCITS managers
- Harmonisation of administrative sanctions regime across member states

Below, we will discuss each item in more detail.

A New Depositary Regime

Under UCITS V each fund is required to appoint a single depositary that should hold all of the fund's assets and provide general oversight to managers and investors. Furthermore, each Member State has the discretion to deem which institutions are eligible to act as UCITS depositaries, with possible candidates being national central banks, EU authorised credit institutions, or "another legal entity" authorised by the member states competent authorities. Capital requirements and effective supervision will be key factors determining whether an institution will be authorised.

The depositary has a safekeeping requirement not only for assets held in custody (including cash) but also for derivatives contracts where recordkeeping and ownership verification needs to be performed. All assets must be held in segregated accounts clearly belonging to the UCITS fund and, in the case of default by the depositary, its creditors shall not have access to the assets.

The depositary is liable to the UCITS fund and its investors for any loss of assets held in custody or for any financial loss caused by any undue delay in returning the assets (unless it can be demonstrated that the loss was caused by an event beyond the depositary's control). The depositary is also liable for losses suffered by the UCITS fund if those losses result from negligence or intentional failure by the depositary. Delegation does not affect the depositary's liabilities as the oversight and cash management function are considered separate from the safekeeping function. Depositaries therefore remain liable for any loss of assets, even if safekeeping duties have been delegated to a third party.

Any securities financing activity by the depositary with the assets held in custody needs to be approved by the UCITS manager. Where it takes place, high quality liquid collateral needs to be posted in return.

Finally, the depositary has a number of oversight duties including the administration (sale, cancellation, re-purchase etc.) of units in the UCITS fund as well as monitoring that the valuation of those units follows all applicable rules. The depositary is also responsible for monitoring all cash flows and ensuring that they end up in the proper accounts.

New Rules Governing Remuneration Policies of UCITS Managers

Under UCITS V, management companies will be required to implement remuneration policies that promote sound risk management and discourage risk-taking in excess of the risk profile of the funds under management. The policies need to address both the fixed and variable component of salaries as well as other discretionary benefits for key people in the management company. This group should comprise of senior management, senior risk takers, senior people in control functions, and specialists with a significant remuneration package.

For this group, at least 50% of any variable remuneration must be paid in unit shares in the fund (or an asset with equivalent incentives) and at least 40% of the variable remuneration should be deferred for at least 3 years. The policies should also apply in a proportional manner to other employees of the management company who have an impact of the risk profile of the fund.

Finally, UCITS V requires greater transparency of remuneration aspects for investors and regulators. In particular, amounts paid to those individuals subject to the remuneration policy must be disclosed, alongside the identities of those on the remuneration committee.

Harmonisation of Administrative Sanctions Regime Across Member States

Since national rules for sanctions on breaches of UCITS IV have displayed discrepancies, the latest UCITS update specifically lists all the circumstances that require sanctions and gives guidelines as to the size of a potential fine, see [EC].

Following the lead of Dodd-Frank, UCITS V further requires competent authorities in each member state to establish a protection programme for whistle-blowers that exposes violations and provides significant evidence. (Under Dodd-Frank, whistle-blowers may also receive a financial reward; whether the European programs will adopt this feature remains to be seen).

For more information about UCITS V and the strategic and operational impact it may have on your investment management business, please contact Stephen McDermott on smcdermott@axxsysconsulting.com or +44 (0) 207 526 4900.

Further Reading

For more details, good summaries can be found in [CC], [PWC] and [NB].

References

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