



UCITS V Directive

By: Dr Andrew Caruana Scicluna
Associate
Camilleri Preziosi Advocates

Introductory Remarks

Although the segregation and safekeeping of client assets has been an integral part of UCITS since its inception, the rules governing depositaries have remained unchanged since the 1985 Directive.

These principles worked well for over twenty-five years, until the Madoff affair and the default of Lehman made it apparent that these rules had not been kept up to date. A simple mapping exercise by ESMA revealed scattered transpositions and widely different interpretations of the depositary rules by different Member States.

The above, coupled with the European Commission's desire to align the UCITS framework with the new rules on depositary liability and manager remuneration under the Alternative Investment Fund Managers Directive ("AIFMD") were the main impetus behind the promulgation of the UCITS V Directive.

Indeed, UCITS V focuses mainly on two issues:

- i. A new depositary regime, which introduces new rules on eligibility, duties, liability and delegation; and
- ii. New rules on manager remuneration.

This Brief provides a high level overview these issues, together with a brief description of the sanctions regime introduced by the revised Directive.

Eligibility

Under UCITS IV, Member States enjoyed discretion as to the entities which were eligible to act as depositaries, as long as such entities were subject to prudential regulation and ongoing supervision. This gave rise to differing levels of investor protection as different types of entities were eligible to act as depositaries in different Member States including credit institutions, investment firms, public institutions (such as central banks), insurance companies and private institutions.



UCITS V addresses this issue by providing for a limited list of entities which may be appointed as depositaries. These are:

- i. Credit institutions (authorised under the Capital Requirements Directive);
- ii. National central banks; and
- iii. Other entities authorised by EU Member States to act as UCITS depositaries which are subject to: (a) capital adequacy and own funds requirements; and (b) prudential regulation and ongoing supervision which satisfy certain other minimum requirements (regarding, amongst others, custody infrastructure, governance and internal control mechanisms).

UCITS V also clarifies that UCITS funds must have a single depositary, whose appointment must be evidenced by means of a written contract.¹

Duties of Depositaries

The principal functions of depositaries under UCITS V are as follows: (i) the safe-keeping function; (ii) the oversight function; and (iii) the cash monitoring function.

Safekeeping

The safekeeping duty is not a novel requirement as the previous iteration of the Directive already required the assets of UCITS funds to be entrusted to a depositary for safe-keeping.

However, UCITS V distinguishes between financial instruments that can be held in custody by the depositary and assets that cannot be held in custody. For financial instruments that may be held in custody, the depositary must (amongst others) ensure that all financial instruments are registered within segregated accounts opened in the name of the UCITS or the management company acting on behalf of the UCITS.

In the case of assets that cannot be held in custody, the obligation of the depositary is to maintain up-to-date records of those assets for which the fund holds ownership and to verify the ownership of such assets based on information provided by the UCITS or management company (and based also on external evidence, where available).

¹ The detail of what such contract must contain will be published by means of a delegated act.



Oversight and Cash Monitoring

A uniform list of oversight duties incumbent on depositaries of UCITS funds is prescribed in the UCITS V Directive. Such list is substantially similar to the oversight duties contained in the previous iteration of the UCITS Directive and includes:

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

However, in addition to the above, depositaries also have a cash monitoring role under UCITS V. This will enhance the ability of depositaries to act as the “eyes of investors” as depositaries will need to have detailed knowledge of the cash balances of UCITS funds and of transfers into and out of the funds’ cash accounts. In particular (and in an analogous manner to the AIFMD), depositaries must ensure that all payments made upon the subscription of units of the UCITS have been received and that all cash of the UCITS has been booked in cash accounts that are opened in the name of the fund.

Delegation

UCITS V clarifies that the only function a depositary is permitted to delegate is its safe-keeping function. Depositaries cannot delegate their fiduciary oversight responsibilities or their cash monitoring responsibilities. Delegation is permitted provided that:

- i. the depositary can demonstrate that there is an objective reason for the delegation;
- ii. the depositary exercises all due skill, care and diligence in the appointment and continuing oversight of any sub-custodian to whom it intends to delegate parts of its tasks;
- iii. the tasks are not delegated with the intention of avoiding the requirements laid down in this Directive;



- iv. the sub-custodian has structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the UCITS which have been entrusted to it.
- v. the sub-custodian segregates the assets of the clients of the depositary from its own assets and from the assets of the depositary in such a way that they can, at any time, be clearly identified as belonging to clients of a particular depositary; and
- vi. the sub-custodian takes all necessary steps to ensure that in the event of its insolvency, the assets of the UCITS held thereby are unavailable for distribution among its creditors.

Further, in the event that the function which has been delegated is the safekeeping of financial instruments which may be held in custody, the sub-custodian must be subject to effective prudential regulation (including minimum capital requirements and supervision in the jurisdiction concerned) and the custody tasks must be subject to an external periodic audit to ensure that the financial instruments are in its possession.

Liability

Under UCITS IV, depositaries were (in accordance with the national law of the UCITS home Member State) liable for: (i) unjustifiable failure to perform their obligations; or (ii) their improper performance of them. Therefore, apart from adopting a negligence-based standard, UCITS IV made reference to national laws to determine the precise contours of depositary liability.

Unsurprisingly, European member states whose nationals were badly affected by the Madoff and Lehman events heavily criticised the absence of a strict liability standard in UCITS IV. Small wonder, this argument proved very effective in political terms in the aftermath of the financial crisis.

As a result, UCITS V introduces a new harmonised standard on depositary liability.

Indeed, in the case of loss of a financial instrument held in custody, UCITS V obliges the depositary to return a financial instrument of the identical type or corresponding amount to the UCITS, without undue delay unless it can prove that the loss arose as a result of an external event beyond its reasonable control. Additionally, depositaries will also be liable to the UCITS (and to investors therein) for all other losses suffered by them as a result of the depositary's negligent or intentional failure to properly fulfil its obligations under the UCITS V Directive.²

² Therefore, in respect of assets which are not held in custody (but which are subject to ownership verification and recordkeeping duties) a depositary will not be liable to return an identical asset but will instead only be found liable if the loss is due to the depositary's negligence or intentional failure as aforesaid.



Unit-holders in the UCITS may invoke the liability of the depositary directly or indirectly through the management company or the investment company. Further, depositary's liability will not be affected by the delegation of safe-keeping duties to a third party and it will not be possible for depositaries to exclude or limit their liability under contract. Indeed, in a departure from the AIFMD, liability may not be contracted out of by depositaries under UCITS V where loss occurs with a sub-custodian.

Manager Remuneration

Overview

UCITS V also contains stringent rules on manager remuneration. This development reflects the trend currently sweeping across the EU, wherein regulatory change is being promoted in order to ensure that remuneration policies promote sound and effective risk management and discourage excessive risk taking.

The remuneration rules under UCITS V broadly reproduce, in many respects, the rules applicable to AIFMs under the AIFMD.

Key Tenets

In line with the approach under the AIFMD, UCITS management companies must establish and apply remuneration policies and practices which are consistent with (and promote) sound and effective risk management, do not encourage risk taking and do not impair compliance with the management company's duty to act in the best interest of the UCITS.

The rules concerning remuneration policies and practices apply to staff whose professional activities have a material impact on the risk profile of the UCITS Manager or of the UCITS it manages, including senior management, risk takers, and any employees receiving similar remuneration packages.

Remuneration Principles Related Pay Out and Risk Alignment

The remuneration policies and practices adopted by UCITS management companies must comply with a number of principles enshrined in Article 14(b) of UCITS V, which deal (amongst others), with governance, pay structure and risk alignment (the "Remuneration Principles").

In a parallel vein to the AIFMD, compliance with such Remuneration Principles must be on a proportionate basis, based on the size and internal organisation of the management company concerned and the nature, scope and complexity of its activities.



Such principles include:

- i. Appropriate balancing of the fixed and variable components of total remuneration such that the fixed component represents a sufficiently high proportion of the total remuneration and there is the option of paying no variable remuneration;
- ii. Guaranteed variable remuneration should be exceptional and occur only with respect to new staff hires in the first year of their engagement;
- iii. the assessment of performance should be set in a multi-year framework appropriate to the holding period recommended to the investors of the UCITS;
- iv. payments relating to the early termination of a contract should reflect performance achieved over time and should be designed in a way that does not reward failure;
- v. a substantial portion (and at least 40 %) of the variable remuneration component, should be deferred over a period which is appropriate: (a) in view of the holding period recommended to the investors of the UCITS concerned; and (b) is correctly aligned with the nature of the risks of the UCITS in question;
- vi. subject to the legal structure of the UCITS and its fund rules or instruments of incorporation, a substantial portion (and at least 50 %) of any variable remuneration component consists of units of the UCITS concerned, equivalent ownership interests, share-linked instruments or equivalent non-cash instruments unless the management of the UCITS accounts for less than 50 % of the total portfolio managed by the management company, in which case the minimum of 50 % does not apply; and
- vii. staff are required to undertake not to use personal hedging strategies or remuneration and liability related insurance to undermine the risk alignment effects embedded in their remuneration arrangements.

As was done with the AIFMD, it would be expected that the MFSA will publish guidance on the applicability of the proportionality principle to the Remuneration Principles.



Remuneration Committee

Management companies that are significant in terms of their size or of the size of the UCITS that they manage, their internal organisation and the nature, scope and complexity of their activities will also need to establish a remuneration committee. Elements which are to be taken into consideration in determining whether a remuneration committee is required include (amongst others): (i) whether the management company is listed or not; (ii) the number of employees of the management company; (iii) the level of assets under management of the management company; and (iv) whether the management company is also an AIFM. ³

Sanctions

UCITS V also seeks to harmonise the administrative penalties in respect of infringements of national provisions transposing the UCITS Directive. In particular, it does so: (a) by setting out a list of minimum types of administrative penalties and other administrative measures applicable to infringements of the UCITS Directive; and (b) providing a list of the criteria which Member States must take into consideration when determining the type and level of administrative sanctions to impose. UCITS V also contains rules on whistleblowing as it requires Member States to establish effective and reliable mechanisms to encourage the reporting of potential or actual infringements of the requirements of the Directive to competent authorities, including secure communication channels for reporting infringements.

Concluding Remarks

UCITS V will occasion further change to an industry still reeling from the implementation of the AIFMD. The market can only hope that the transposition of UCITS V into national law will, to the extent possible, be streamlined with the provisions transposing the AIFMD in order to ensure unnecessary complexity for market players; in particular, managers managing both UCITS and AIFs and depositaries holding custody of both UCITS.

³ ESMA Consultation Paper on Guidelines on sound remuneration policies under the UCITS Directive and AIFMD (2015/ESMA/1172), page 70.

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