Grant Thornton
An instinct for growth™

Transitioning from UCITS IV to UCITS V

Applying the lessons learnt from implementing the AIFMD

Key impacts of UCITS V

Fund managers	
Remuneration	Establishment or amendment to an existing remuneration policy in order to meet the detailed requirements of UCITS V. Its implementation is to be overseen by non-executive members of the management body.
Depositary duties	The volume, type and frequency of information that must be shared by fund managers with their depositary will increase substantially. When looking to change or appoint a depositary, fund managers may also be required to migrate away from their other existing service providers (e.g. transfer agency or fund administration) as a condition for the provision of depositary services.
Depositary liability	Liability rules will affect a depositary's operating model. Subsequent changes will be reflected in its service level agreements and processes with its fund manager clients. Liability will increase depositary service charges, which may, in turn, lead fund managers to review their total expense ratio.
Transparency	Disclosures to regulators and to investors will increase and necessitate fund managers to review all elements of their operating model.

Depositaries	
Depositary eligibility	The depositary must ensure that it is registered as a credit institution in the EU or Markets in Financial Instruments Directive (MIFID) investment firm.
Depositary regime duties	Duties such as cash flow monitoring will require an increase in the volume, type and frequency with which information is shared by both fund managers and their service providers. As depositary duties are closely aligned to those of transfer agents and fund administrators, the largest depositaries should seek to exploit economies of scale to offer competitively priced bundled service offerings.
Depositary liability	Restitution liability will have a particularly high impact on operating models to service UCITS fund managers that appoint prime brokers and UCITS fund of funds. Depositary services rate cards will need to be updated to reflect the liability regime.
Delegation of duties	Minimum capital and asset ring-fencing requirements, together with an inability to discharge liability, will necessitate a review of the breadth of markets offered and enhancements to the due-diligence process for agents within the existing sub-custodian network (especially in developing markets).

Introduction

Financial institutions around the world continue to struggle with the numerous regulatory changes that followed the global financial crisis. The transition from Undertakings for Collective Investment in Transferable Securities (UCITS) IV to UCITS V is a clear example of the shift in regulator's mentality after the economic crisis. While the former focused on enhancing market efficiency by enabling fund managers to operate across EU member states, the latter seeks to address some of the vulnerabilities exposed by the Madoff and Lehman Brothers incidents.

The UCITS V Directive (or the "Directive") was published in the Official Journal of the European Union (OJ) in August 2014. This follows the Directive being adopted by the European Parliament and the Council of the EU in April 2014 and July 2014 respectively. The Directive came into force on 17 September 2014 and member states have to transpose it into their domestic laws, regulations and administrative provisions by 18 March 2016.

With investor protection as one of its key objectives, the European Commission's (EC's) attention has been drawn back to the UCITS Directive due to different interpretations and inconsistencies in its implementation across member states.

Additionally, the advent of the Alternative Investment Fund Managers Directive (AIFMD), which had to be implemented by July 2013, subject to certain transitional arrangements, has led the EC to address the imbalance between the level of investor protection afforded to those investing in UCITS and those investing in Alternative Investment Funds (AIFs). The UCITS V Directive covers three main areas: remuneration, the depositary regime and regulatory sanctions.

Grant Thornton sees UCITS V as a case of 'more of the same' when compared to the AIFMD as many of the changes are aligned with (and to some extent exceed) the benchmark set by the AIFMD. Therefore considering UCITS V early, whilst simultaneously comparing the changes to the AIFMD, will benefit financial institutions.

Depositary regime

The reform of the depositary regime seeks to harmonise depositary liability and duties across the EU. In its impact assessment, the European Commission stated that the variances in the application of the depositary regime across the EU could cause significant legal uncertainty and lead to different levels of investor protection.

1) Depositary eligibility

The appointment of a depositary will need to be supported by a written contract charging the depositary with the safekeeping, oversight and cash flow monitoring duties. Under UCITS V, only the following institutions are eligible to act as depositaries:

- EU authorised credit institution; and
- MiFID investment firms that provide safekeeping and administration ancillary services and are subject to capital standards.

There is also a grandfathering period if the incumbent depositary does not meet the criteria above.
These provisions, although not identical, are a close reflection of the AIFMD rules.

2) Delegation of duties

Under UCITS V, cash monitoring and oversight cannot be delegated. However, the regulation introduces new conditions for the delegation of safekeeping duties. The depositary must have an 'objective reason' for the delegation and exercise due diligence in the selection and appointment of the third party.
One of the key differences between UCITS V and the AIFMD is that assets relating to the UCITS funds must be ring-fenced so in the event of default by the depositary or its delegate, UCITS funds' assets are not available for distribution to creditors.

3) Depositary liability

UCITS V aligns depositary liability rules with those of the AIFMD by establishing an enhanced duty of care. In respect of its safekeeping duties, depositaries have a restitution liability for losses of any ‘financial instruments held in custody’. So if found liable, the depositary is required to replace the assets lost without undue delay. The depositary can be exempted from this duty where it can prove that the loss has arisen as a result of an external event beyond its control. Naturally, the burden of proof will be on the depositary.

In contrast with the AIFMD, where depositaries are permitted, in marginal scenarios, to discharge their liability onto their safekeeping delegates, UCITS V makes no such allowances. Therefore, depositaries remain liable for the loss of assets even when all or part of their safekeeping duties have been delegated to a third party.

Industry participants are concerned that higher liability obligations will result in higher depositary fees. Once again, the implementation of AIFMD will shed light on the subject.

4) Other provisions

The re-use of assets under UCITS V is another key difference to the AIFMD. Under UCITS V, assets held in custody by the depositary (or its delegates) can only be re-used under the instruction of the fund manager and as long as the re-use is for the investor’s benefit. Moreover, any re-use that involves the transfer of title (e.g. stock lending or rehypothecation) requires high quality liquid collateral (which has been subject to an appropriate haircut) to be posted in return.

Remuneration rules

The remuneration debate was one of the most contested points in the negotiation of the amendments to the Directive and a proposed bonus cap was voted down by the European Parliament at the plenary session. The remuneration rules adopted under UCITS V require fund managers to establish remuneration policies and practices that are consistent with sound risk management and discourage disproportionate risk-taking.

Fund managers must ensure that a remuneration committee is established and a remuneration policy implemented. The implementation of the policy must be overseen by non-executive members of the fund's management body and the contents of the policy itself must comply with a number of principles. These principles include who the policy applies to, when it should be reviewed and by whom, conditions regarding the make-up of bonuses (eg at least 50% must consist of units of the UCITS fund concerned) and conditions regarding when bonuses can be paid (e.g. at least 40% is to be deferred for at least three years). It should be noted that UCITS managers will however have the flexibility to apply their remuneration policies in a manner proportionate to the UCITS size as well as the scale and complexity of its activites.

UCITS V also requires greater access to and disclosure of the remuneration policy to investors and regulators. Remuneration amounts paid must also be disclosed, as must the identities of those on the remuneration committee.

The rules are consistent with the AIFMD, so once again, the implementation of AIFMD will shed some light on this subject. But it should be noted that, in certain areas such as the transparency and disclosure, UCITS V rules exceed those within the AIFMD.

Sanctions regime

UCITS V contains an exhaustive list of breaches that will be sanctioned by competent authorities. The purpose of this list is to harmonise the sanctions regime across Member States in order to reduce regulatory arbitrage and impose a consistent behaviour across fund managers.

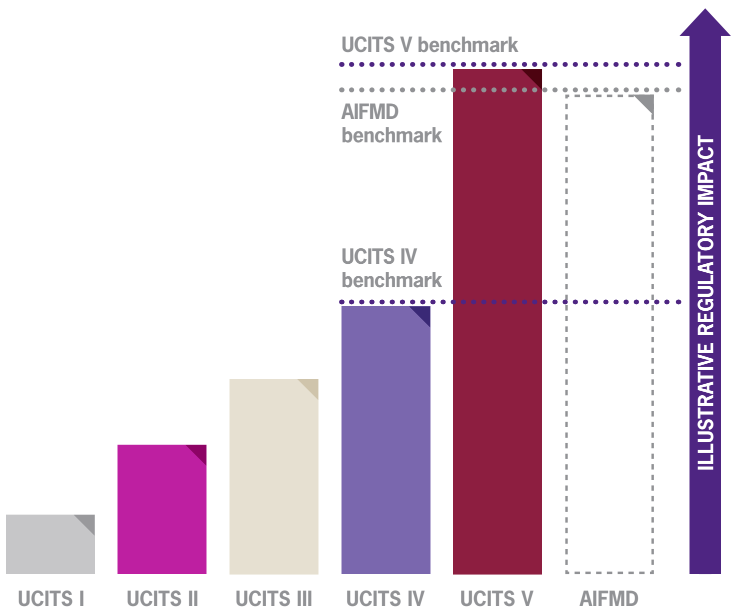
Member states can apply criminal sanctions or administrative sanctions to a maximum of €5 million or 10% of the annual turnover for corporations and up to €5 million for individuals. The sanctions will be published on the national regulators' websites for a minimum of five years. European Securities and Markets Authority (ESMA) will also manage a central database with all the sanctions and infringements.

Conclusion

Financial institutions now have just over six months remaining to consider the impact of the latest iteration of the Directive and prepare for its implementation. Grant Thornton believes a firm's ability to absorb the impact of UCITS V will differ depending on its level of experience in implementing the AIFMD.

As stated, some of the requirements of UCITS V are aligned (and sometimes exceed) those within the AIFMD. Firms required to implement both regulations have an opportunity to build upon the momentum, structure and lessons learned from a recent AIFMD change programme and transfer this over to front-running UCITS V.
Firms affected by the AIFMD have gone through unexpectedly complex and prolonged periods of change to meet the requirements.

Therefore, those firms that are yet to experience implementing the AIFMD, will face significant challenges to adapt to the requirements of UCITS V (particularly the new depositary regime).
Given the scale of change required, these firms should consider mobilising a change programme in response to UCITS V as soon as possible.



There has been a significant amount of difficulty interpreting, obtaining clarity and implementing the requirements of the AIFMD, so experience indicates that the impact of moving from UCITS IV to UCITS V should not be underestimated.

Contact

Niamh Meenan
Partner, Global Head of Asset Management
T+353 (0)1 6805 614
E niamh.meenan@ie.gt.com

John Glennon
Partner, Financial Services Audit
T+353 (0)1 6805 630
E john.glennon@ie.gt.com

Maura Cronin
Director, Financial Services Audit
T+353 (0)1 6805 947
E maura.cronin@ie.gt.com

David Lynch
Director, Financial Services Audit
T+353 (0)1 6805 923
E david.lynch@ie.gt.com

24-26 City Quay, Dublin 2, D02 NY19

Over 1000 people operating from offices in Dublin, Belfast, Cork, Galway, Kildare, Limerick and Longford.

@GrantThorntonIE www.grantthornton.ie

Grant Thornton
An instinct for growth™