# Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>BACKGROUND</td>
<td>2</td>
</tr>
<tr>
<td>DEPOSITARY REQUIREMENTS</td>
<td>2</td>
</tr>
<tr>
<td>ELIGIBILITY</td>
<td>2</td>
</tr>
<tr>
<td>DELEGATION</td>
<td>3</td>
</tr>
<tr>
<td>DEPOSITARY LIABILITY</td>
<td>4</td>
</tr>
<tr>
<td>DUTIES OF THE DEPOSITARY</td>
<td>5</td>
</tr>
<tr>
<td>REMUNERATION</td>
<td>5</td>
</tr>
<tr>
<td>SANCTIONS REGIME</td>
<td>6</td>
</tr>
<tr>
<td>TIMELINE AND NEXT STEPS</td>
<td>7</td>
</tr>
</tbody>
</table>
UCITS V DIRECTIVE - UPDATE

Background

On February 25, 2014, following the trilogue negotiations among the European Parliament, the European Council and the European Commission, agreement was reached in relation to the European Commission’s set of proposals to strengthen the rules for undertakings for collective investment in transferable securities (“UCITS”). This concluded the negotiations in relation to the draft UCITS V proposals which were originally put forward by the European Commission in July 2012 with the aim of addressing lessons learned from the financial crisis, most notably in connection with the Madoff fraud and the Lehman Brothers default which revealed material divergences in rules on depositary duties and liabilities across EU member states. The new rules are designed to significantly increase the level of protection enjoyed by UCITS investors and are seen as a key step towards restoring investor confidence in the wake of the financial crisis.

As set out in the Dillon Eustace brochure headed “UCITS V Directive”, published in July 2012, UCITS V focuses on three main areas, namely, (i) clarification of the UCITS depositary’s eligibility, its functions and its liability in circumstances where assets in custody are lost; (ii) rules governing remuneration policies; and (iii) the harmonisation of the minimum administrative sanctions regime across Member States.

Depositary Requirements

Eligibility

Under original UCITS V proposal, the depositary must be either a credit institution or a MIFID investment firm. In the compromise text agreed at the end of February, and as proposed by the European Council, a third category of eligible depositary has also been included, namely, any other legal entity authorised by the competent authority under the laws of the Member State to carry on depositary activities which is subject to capital adequacy and own funds requirements and which is subject to prudential regulation, ongoing supervision and satisfies certain minimum requirements, including requirements in relation to infrastructure, experience, administrative and accounting procedures, internal control mechanisms, procedures for risk assessment and arrangements to prevent conflicts.

This third category of eligible depositary is a welcome development given that in Ireland only a small minority of entities authorised by the Central Bank to provide depositary services would have fallen
within the narrow categories of credit institutions or of MiFID firms as proposed in the Commission’s original proposals.

Existing depositaries of UCITS who do not fall into the above three categories will have a 2 year grandfathering period within which to convert into eligible entities.

**Delegation**

The original UCITS V proposals in relation to the delegation of custody will now be aligned with those set out in the Alternative Investment Fund Managers Directive (“AIFMD”). Under UCITS V, a UCITS depositary will only be permitted to delegate all or part of its safekeeping tasks to a sub-custodian where certain conditions are satisfied, including:

(i) the tasks are not delegated with the intention of avoiding the requirements of the UCITS Directive;

(ii) there must an objective reason for the delegation; and

(iii) the depositary must exercise all due skill, care and diligence in the selection and appointment of any sub-custodian and there must be periodic review and ongoing monitoring of the sub-custodian.

The depositary must also determine that the sub-custodian itself satisfies certain requirements during the performance of the tasks delegated to it, including the requirement to have structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the UCITS. The sub-custodian must also segregate the assets of the depositary’s clients from its own assets and from the assets of the depositary so that they can be clearly identified as belonging to the clients of the depositary.

In circumstances where the appointment of a sub-custodian is required under local law, the depositary may appoint a local entity which does not satisfy the delegation requirements set out in UCITS V provided that investors are informed that the delegation is required due to local legal constraints in such third country are informed, of the circumstances of the delegation and are informed “of the risks involved in such delegation” (the latter text having been agreed in the final compromise text).

Assets held in custody will not be permitted to be reused by the depositary or any third party unless certain conditions are met, including a new requirement set out in the final compromise text that the transaction “is covered by high quality and liquid collateral received by the UCITS under a title transfer arrangement” where the market value of the collateral is at all times at least equal to the market value of the reused assets plus a premium.
It is also of note that, notwithstanding the wording put forward by the European Council and the Parliament in earlier drafts of the Directive, the final compromise text provides that UCITS will be required to disclose in its prospectus a description of any safekeeping functions delegated by the depositary, the list of delegates and sub-delegates and any conflicts of interest that may arise from such delegation.

This new provision can be distinguished from the requirement in the AIFM Directive which merely stipulates that such information should be made available to investors (not that it must be disclosed in the prospectus).

**Depositary Liability**

With the aim of harmonising depositary liability under UCITS V, new requirements in relation to depositary liability have been introduced. Similar to AIFMD, UCITS V distinguishes between:

(i) financial instruments that are capable of being held in custody, where the depositary will be liable for the loss of such assets on a strict liability basis (i.e. irrespective of fault or negligence) unless the depositary can prove that the loss of assets is due to an “external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary”; and

(ii) all other assets (such as OTC derivatives), which are subject to recordkeeping and ownership verification duties and where the depositary will only be liable if a loss is suffered as a result of its negligence or intentional failure to properly fulfil its obligations under the Directive.

In the case of (i) above, a UCITS depositary is obliged to return a financial instrument of the identical type or corresponding amount to the UCITS, without undue delay, if it is deemed liable for the loss.

In addition, the depositary’s liability will not be affected by the fact that it has entrusted to a third party all or some of its custody tasks. Therefore, the depositary will be liable for the loss of assets even where the loss occurred at the level of the sub-custodian. Unlike depositaries of alternative investment funds, which are permitted under AIFMD to transfer liability for the loss of financial instruments held in custody to the relevant sub-custodian, depositaries of UCITS will not be permitted to exclude or limit their liability under contract. In its original proposal, the Commission noted that it would be inappropriate and unfeasible to require retail investors to understand the consequences of such contracts.

UCITS V also gives new rights to all UCITS investors so that they are able to directly or indirectly have recourse to the UCITS depositary. The final compromise text states that such right of recourse shall be
subject to the condition that “this does not lead to a duplication of redress or to unequal treatment of the unitholders”.

**Duties of the Depositary**

In addition to the new safekeeping requirements which, as above, distinguish between (i) financial instruments that can be held in custody by the depositary and (ii) record keeping and ownership requirements relating to other assets, UCITS V includes a uniform list of oversight duties (similar to the existing oversight duties applicable to depositaries of Irish UCITS) as well as new cash flow monitoring requirements. Similar to AIFMD, UCITS depositaries will now be required to ensure that the cash flows of UCITS are properly monitored and to ensure that all payments made by or on behalf of an investor upon the subscription of units have been received and that all cash has been booked in cash accounts that meet certain conditions.

Furthermore, in performing its tasks, a depositary will be obliged to act honestly, fairly, professionally, independently and in the interest of the UCITS and its investors.

**Remuneration**

Of considerable interest are the new provisions being introduced in relation to remuneration. Consistent with the approach adopted under AIFMD, UCITS V provides that Member States shall require management companies to establish and apply remuneration policies and practices that are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS they manage and do not impair compliance with the management company’s duty to act in the best interests of the UCITS.

The remuneration policies and practices will apply to those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that falls within the remuneration bracket of senior management and risk takers whose professional activities have a material impact on the risk profiles of the management companies or of the UCITS they manage.

Following the introduction of UCITS V, UCITS managers’ remuneration structures will be required to include:

(i) criteria for calculating compensation for different categories of staff;

(ii) a ban on guaranteed variable remuneration except in exceptional circumstances;
(iii) rules for fixed and variable components of total remuneration (including a requirement that at least 50% of any variable remuneration is in the form of units of UCITS);

(iv) rules on pension benefits; and

(v) rules for payments related to early termination of employment (to ensure that failure is not rewarded).

UCITS managers will, however, have the flexibility to allow for the sound application of the remuneration policies in a manner proportionate to its size, its internal organisation as well as the nature, scale and complexity of its activities.

A new requirement in the final compromise text of the Directive provides that details of the up to date remuneration policy (including a description of how remuneration and benefits are calculated, the identities of persons responsible for awarding the remuneration and benefits) will need to be disclosed in the Prospectus. Alternatively, the remuneration policy may be summarised in the Prospectus, provided a statement is included that further details of the policy are available by means of a website and that a paper copy is available to investors free of charge upon request (this information must also be disclosed in the Key Investor Information Document).

Recital 2 of the Directive suggests that the remuneration rules shall apply also to UCITS self-managed investment companies. Recital 2 also states that the remuneration policies and procedures should apply “in a proportionate manner, to any third party which takes investment decisions that affect the risk profile of the UCITS because of functions which have been delegated in accordance with Article 13”. This latter text, which did not appear in earlier drafts of the Directive, may catch US managers offguard and concerns have arisen that such provisions could deter US fund staff from managing mainstream European funds. The requirement for managers to receive a minimum of 50% of their bonuses in units of the fund they manage is particularly problematic as US nationals cannot own shares of UCITS. However, it may be that US (and other third party) managers can rely on the fact that the UCITS accounts for less than half of the total portfolios under management by such entity (in which case the minimum of 50% above does not apply). In the meantime, it will be interesting to see how Recital 2 is interpreted by the European Securities and Markets Authority (ESMA), who are expected to issue guidelines on remuneration policies in the coming months.

Sanctions Regime

In order to harmonise the application of sanctions across member states, UCITS V sets down an exhaustive list of breaches which require sanctions by competent authorities. The final proposed text also sets out a minimum list of administrative sanctions and measures which may be applied in the
event of any such breach, including prescriptive limits on fines which may be imposed by competent authorities.

Other measures being introduced are the requirement for Member States to establish effective mechanisms to encourage the reporting of breaches and to provide a secure channel to enable such communication. The proposals also require appropriate protections to be put in place for employees of UCITS management companies and investment companies who report breaches committed within the company.

**Timeline and Next Steps**

Following the agreement reached on February 25, 2014, it is expected that the final UCITS V Directive will be published in the Official Journal shortly. Member States will then have eighteen months from the date of publication to transpose the Directive into their domestic laws, during which time it is expected that implementing measures providing greater clarity on certain provisions of UCITS V will be issued.

In preparation for the transposition date, which is now likely to fall in 2015, UCITS and UCITS managers will need to consider how the new requirements will impact on their depositary arrangements, remuneration structures and fund documentation. In particular, the following steps will need to be taken:

- **Depositaries** will need to analyse and assess the impact of the new depositary safekeeping, delegation and liability provisions. In particular, sub-custody arrangements will need to be reviewed to determine what changes will be required to the existing due diligence process. Depositaries will also need to review their capabilities in order to discharge the new cash monitoring oversight duties. Custody contracts will need to be updated to reflect the new safekeeping and oversight duties and, in particular, to reflect the relevant changes to liability standards. The new requirements in relation to delegation will also require depositaries to amend their sub-custodian agreements to ensure that all of the requirements imposed on delegates under UCITS V are reflected in the contractual arrangements.

- **UCITS managers** will need to review their existing remuneration policies and to examine which members of staff and which employment contracts may be impacted. Managers will also need to review their delegation arrangements and to identify what third parties to whom functions have been delegated may be impacted by the new rules.

- **UCITS** will need to review their fund documentation. In particular, it will be necessary to update the Prospectus to reflect the new disclosure requirements in relation to remuneration and
depositaries; Key Investor Information Documents will also need to be reviewed. Business Plans will also need to be examined to reflect details of the remuneration policy.

- Annual accounts will need to be updated to reflect the new disclosure requirements in relation to remuneration.

Date: April 2014  
Author: Benedicte O’Connor
CONTACT US

Our Offices

Dublin
33 Sir John Rogerson’s Quay
Dublin 2
Ireland
Tel: +353 1 667 0022
Fax: +353 1 667 0042

Cayman Islands
Landmark Square
West Bay Road, PO Box 775
Grand Cayman KY1-9006
Cayman Islands
Tel: +1 345 949 0022
Fax: +1 345 945 0042

Hong Kong
604, 6/F, Printing House
6 Duddell Street
Central
Hong Kong
Tel: +852 35210352

New York
245 Park Avenue
39th Floor
New York, NY 10167
United States
Tel: +1 212 792 4166
Fax: +1 212 792 4167

Tokyo
12th Floor,
Yurakucho Itocia Building
2-7-1 Yurakucho, Chiyoda-ku
Tokyo 100-0006, Japan
Tel: +813 6860 4885
Fax: +813 6860 4501

e-mail: enquiries@dilloneustace.ie
website: www.dilloneustace.ie

Contact Points

For more details on how we can help you, to request copies of most recent newsletters, briefings or articles, or simply to be included on our mailing list going forward, please contact any of the team members below.

Andrew Bates
E-mail: andrew.bates@dilloneustace.ie
Tel: + 353 1 673 1704
Fax: + 353 1 667 0042

DISCLAIMER:
This document is for information purposes only and does not purport to represent legal advice. If you have any queries or would like further information relating to any of the above matters, please refer to the contacts above or your usual contact in Dillon Eustace.

Copyright Notice:
© 2014 Dillon Eustace. All rights reserved.