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EU Commission Publishes Draft UCITS V Directive

The European Commission published its proposed amendments to the current UCITS framework on 3 July 2012. These amendments, in the form of a draft UCITS V Directive, are intended to extend the investor safeguards included in the alternative investment fund managers directive (AIFMD) to retail investors (albeit with some crucial changes reflective of the UCITS investor profile). The draft Directive focuses on three areas, namely: depositaries, remuneration policies for UCITS management companies and sanctions for core breaches of the UCITS legal framework.

Background

Since the introduction of UCITS as a new investment product in 1985, the rules concerning UCITS depositaries have remained unchanged. They currently consist of a number of generic principles setting out the duties of depositaries and their liability towards investors. The Commission notes that as a result different approaches to the scope of a depositary's duties have developed across the EU, leading to uneven levels of investor protection. The potential consequences of such divergences in liability standards were highlighted by the Lehman bankruptcy and the Madoff fraud. In addition, the Commission is of the view that the remuneration and incentive schemes for fund managers have led to short-term decision making and encouraged excessive risk-taking. Finally, the Commission has carried out an analysis of national supervision regimes and found that a number of divergences and weaknesses exist which may ultimately have a negative impact on the stability and integrity of financial markets and on investor protection.

Key Proposals

Depositaries

Eligibility Criteria – the current UCITS framework provides little clarity on the institutions eligible to act as a UCITS depositary and therefore gives a certain degree of discretion in this regard to Member States. This has led to divergent approaches across the EU. The draft UCITS V Directive provides that only two categories of entities will be capable of acting as a UCITS depositary, namely: (i) EU authorised credit institutions; or (ii) MiFID authorised investment firms providing safekeeping and administration services. The draft contains a two-year grandfathering period during which UCITS will be permitted to use a non-compliant depositary. These provisions are not final and the funds industry is seeking to propose that additional categories of eligible depositaries be included as per the AIFMD and the Irish Central Bank's rules for UCITS and Non-UCITS.

Delegation of Custody – UCITS now invest in a much greater number of countries and in more complex instruments than in 1985. This increases the necessity to appoint sub-custodians in various jurisdictions. The Commission notes that the current UCITS framework lacks clarity in relation to the conditions applicable to the delegation of custody to sub-custodians and it is in this context that new due diligence and on-going monitoring requirements are to be introduced. Accordingly, the draft Directive defines the conditions upon which the depositary's safekeeping duties can be delegated to a sub-custodian. Essentially, the conditions and requirements upon which a UCITS depositary may entrust its safekeeping duties to a third party are aligned with those applicable under the AIFM Directive. It should be noted that, in the case of the insolvency of a safekeeping delegate, securities held by them will not be available for distribution to their creditors. The draft UCITS V

Directive delegates to the Commission the power to further define the depositary's initial and on-going due diligence duties, including those that apply to the selection and appointment of a sub-custodian.

Liability – the existing standard of liability for loss of a financial instrument held in custody is that it arises in case of “unjustifiable failure to perform obligations” or “improper performance” of such duties. These terms have been interpreted differently in various Member States, which has led to diverging levels of investor protection. The draft UCITS V Directive introduces a “strict liability” standard obliging depositaries to return financial instruments lost in custody irrespective of fault or negligence, with the exception of losses caused by an external event beyond the depositary's reasonable control. Depositaries will remain liable for the loss of assets in cases where safekeeping duties have been delegated to a third party. The draft UCITS V Directive, in contrast to the AIFMD, therefore holds the depositary liable for the return of the financial instrument, even if the loss occurred with the sub-custodian, without the possibility to discharge the liability by contract. It should be noted though that there is still some uncertainty around the categories of risk for which the depositary is liable. It has been suggested that if depositaries are held liable for investment losses “in all circumstances”, they would effectively become “insurers” for risks beyond their control. To the extent that depositaries are forced to accepting greater liability, then their costs will increase. Such costs are likely to be borne by the end investor.

Prospectus Disclosure – it is proposed that a description of any safekeeping functions delegated to a third party by the depositary be included in the UCITS prospectus. Such disclosure will be required to identify the delegate and any conflicts of interest which may arise from the delegation. While this provision corresponds to the disclosure requirement included in the AIFMD in terms of the level of disclosure required, it goes further in requiring that this information be provided in the prospectus of a UCITS, not that it simply be provided to investors, as stated in the AIFMD. This provision will pose both practical and operational challenges and, as such, is the subject of intense lobbying by industry bodies, such as the IFIA.

Remuneration of UCITS Managers

The Commission proposes that a requirement be introduced for UCITS management companies to implement remuneration policies consistent with sound risk management and which discourage disproportionate risk-taking - increased risk exposes investors to higher potential losses than might be expected given the risk profile disclosed to the investors. These policies and practices will apply to senior management and persons whose professional activities have a material impact on the risk profile of the management company or the UCITS. These provisions of the draft Directive correspond to the relevant provisions of the AIFMD.

The Commission has not confirmed if the requirement to implement the remuneration policies described in the draft Directive will be applicable in cases where a self-managed UCITS or UCITS management company does not receive an asset based fee.

Administrative Sanctions

Following the Commission's analysis of the national rules on sanctions for breaches of the UCITS Directive, the Commission has concluded that there is a significant divergence between jurisdictions both in the criteria being applied to issuing sanctions and the level of sanctions being applied to specific breaches. The draft UCITS V Directive requires that EU Member States empower their regulatory authorities with the wide-ranging investigative powers and administrative sanctions set out in the draft Directive covering a range of breaches of regulatory provisions. proposes harmonisation of the sanctioning regimes by requiring the national regulators to introduce catalogues of sanctions and other punitive measures, and lists of sanctioning criteria.

Implementation

The draft Directive will now be presented to the European Parliament and the Council for their consideration under the co-decision procedure. Once an agreement on the text is reached, Member States will have two years to transpose the provisions into their national laws, meaning that the new rules could apply by the end of 2014. By this date, the necessary package of implementing measures should also be adopted.

For further information, please contact our Partners listed below or your usual contact in our Asset Management and Investment Funds Team.

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EU Commission Publishes Proposals for a "Key Information Document" for Non-UCITS Retail Investment Products

The EU Commission has published its legislative proposals for the application of the principles of the UCITS KIID regime to all other retail investment products. These products are collectively referred to by the Commission as Packaged Retail Investment Products (PRIPs). The Commission considers that PRIPs can be categorised into four groups; investment funds, insurance-based investment products, retail structured securities (such as certificates and notes), structured term deposits and private pensions.

The aims of the Commission's proposal are as follows: (a) to achieve consistent and effective standards for investor protection across a wide range of retail investment products through enhanced product disclosure; (b) to ensure that there is a level-playing field for distributors and providers of these products; (c) to ensure that the features of different retail investment products are easily comparable; and (d) to ensure that the key features and risks of retail investment products can be easily understood by retail investors.

Background

To protect investors, sectoral measures that require defined information to be provided to retail investors have been developed over time. However, the existing measures have proven in some cases ineffective – requirements vary according to the legal form of investment products, not their economic nature or risks. This lack of standardisation makes it more difficult for retail investors to compare products and properly understand product features. In its April 2009 Communication on PRIPs, the Commission concluded that such failings could be traced (amongst other things) to the lack of a common framework and approach to product disclosures at the European level, which could only be addressed by legislative change at the European level.

Key Provisions

The Commission's proposal requires that each PRIP be accompanied by a standard information sheet ('key information document' or KID), providing clear and comparable information, set out in the same format for all PRIPs so that retail investors are able to compare different investment products. The KID should be written in a concise manner, in non-technical language and that avoids jargon so as to be understandable by the average or typical retail investor.

The proposal specifies the essential elements of the investment product which should be described in the KID: the identity of the product and its manufacturer, the nature and the main features of the product, including whether investors might lose capital, its risk and reward profile, costs, and past performance as appropriate. Other information may be included for specific products, and information about possible future outcomes should be provided for private pension products. The proposal sets out a common format and sequence of sections to promote comparability.

The KID will differ from the UCITS KIID on a number of points:

- While the KIID is only two pages long, it is intended that the KID will be "no more than a few pages long"
- A KID will be expected to contain answers to a set of "standard" questions and these may include: "What is the investment? Can I lose money? What are the risks and what might I get back? What are the costs?"
- KID will contain risk information, a risk indicator directly comparable with that for UCITS, and information on the real costs of different products, "so they can be compared in a neutral and objective way"



KIIDs, by contrast, include only investment objectives, a risk and reward synthetic indicator, past performance and charges.

The Commission has concluded that investment products caught under PRIPs legislation are designed differently than UCITS, which is why an identical KIID model could not be adopted. It has stated that KIIDs contain information that is not relevant for some of the other investment products being sold in Europe; and, in some cases, other investment products have features not found in UCITS – such as insurance benefits or fixed investment terms. In addition, the kinds of risks these products have can also be different.

It is expected that the KID will replace the key investor information documents (KIIDs) for UCITS following a 5-year transitional period commencing on the entry into force of the Commission's KID proposal as outlined above.

Implementation

The Commission's proposal will now be presented to the European Parliament and the Council for their consideration under the co-decision procedure. Once an agreement on the text is reached, detailed work will be done by the Commission with the input of experts, consumers and stakeholders on the implementing measures. The full proposal could be expected to be in place by the end of 2014.

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