

UCITS V - level 2 rules issued by the Commission and ESMA Q&A update

11 February 2016

In brief

Three months before the UCITS V Directive¹ implementation deadline on 18 March 2016 the draft Commission Delegated Regulation as regards UCITS' depositaries obligations (the "draft level 2 rules")² was issued by the EU Commission on 17 December 2015. It is no surprise that these draft level 2 rules are to a large extent carried out from the rules applying to the depositaries subject to the AIFM Directive and the associated level 2 rules (together the "AIFM rules"). However, differences exist. In particular, attention should be paid to the conditions for fulfilling the independence requirements between the depositary and the management company.

On 1 February 2016, ESMA published an updated version of its Q&A (2016/ESMA/181 - the "Q&A") replacing the 4 previous Q&As, dealing with the implementation of UCITS V and specifically the applicable deadlines for updating the KIID, the prospectus, the annual report and the depositary contract with the new UCITS V disclosure requirements.

The remuneration provisions in the UCITS V Directive will be clarified in guidelines; these Guidelines are still expected and should apply only as from 1 January 2017.

What's new?

Draft level 2 rules

As regards the UCITS' depositary regime, the draft level 2 rules contain similar requirements as those of the AIFM rules. There are however certain differences that we highlight below.

- **Depositary agreement (article 2 of the draft level 2 rules)** – Article 2 provides a description of the provisions that the depositary agreement signed with the UCITS (or the management company in case of an FCP) must contain. The AIFM rules contain similar requirements. However, contrary to the provisions in the AIFM Directive, the depositary agreement does not need to refer to the case where the depositary or any sub-custodian may reuse any of the UCITS' assets for their own account. The reason for this is that UCITS V prohibits the depositary or a sub-custodian to reuse the UCITS' assets for their own account.
- **Oversight duty – valuation of units and shares (article 5)** – Contrary to the AIFM rules, there is no requirement for the UCITS depositary to perform compliance checks on so-called "external valuers". This is because this concept of external valuer, which exists in the AIFM Directive, has not been introduced in UCITS V (or in earlier versions of the Directive).

¹ Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions.

² Commission Delegated Regulation (EU) .../... of 17 December 2015 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries.

- **Safekeeping of assets (articles 13 and 14)** – Neither the UCITS V Directive nor the draft level 2 rules contain look-through provisions to underlying assets, in the context of the depositary’s safekeeping duties. This is probably because the EU regulator did not consider the possibility for UCITS to have recourse to special purpose vehicles in certain cases. Also, all target funds in a UCITS, must have a depositary.
- **Insolvency protection of UCITS assets when delegating safekeeping function to a sub-custodian (articles 15 and 17)** – A depositary shall make sure that a sub-custodian situated in a non EU country takes all necessary steps to ensure asset segregation and that, in the event of bankruptcy, the UCITS assets remain segregated and unavailable for distribution to the creditors of the sub-custodian in accordance with local insolvency laws. This assessment by the sub-custodian should be based on a legal advice from an independent source. The obligations in this paragraph apply *mutatis mutandis* in case of further delegation by the sub-custodian (to a “sub-sub-custodian”).
- **Common management between the management company and the depositary (article 21)** – The draft level 2 rules require that the board of directors of the management company shall not comprise any member of the board of directors or any employee of the depositary, and vice-versa. Where the management company has a supervisory body (on top of the board of directors – a so-called “two tier” governance system which is not frequent in Luxembourg), only 1/3 of the members of the supervisory body may be member of the supervisory body, a member of the management body or an employee of the depositary, and vice-versa. Note that these provisions do not extend to the delegates of the depositary (sub-custodians), as it was the case in the prior draft version of the level 2 rules.
- **Appointment of depositary and delegation of safekeeping (article 22)** – The selection of the depositary by the investment company or management company shall be based on a set of pre-defined criteria and follow a documented decision making-process.

In addition, an investment company or management company may only appoint a depositary to which it has a link or a group link, if its decision is based on a quantitative (incl. cost elements) and qualitative comparison of the merits of appointing such depositary against an independent depositary. In any case, the investment company or management company shall ensure that the depositary is appointed in the sole interest of the UCITS and its investors and be able to justify its choice to investors and to its supervisory authority. As an aside, the depositary shall also base the choice of its delegates on pre-defined criteria and in the sole interest of the UCITS and its investors.

- **Management of conflicts of interest in case of cross-shareholdings (articles 23 and 24)** – Where a link or a group link exists between them, the management company or the investment company and the depositary shall make sure that their conflicts of interest policy take such link into account. They must also comply with the following additional independence requirements:
 - Entities with a one-tier governance system (i.e. typically, a board of directors also in charge of supervisory functions) shall make sure that 1/3 (to be rounded down in case of fractions³) or 2 persons (whichever is the lower) of the members of the board of directors are independent.
 - Entities with a two-tier governance system (as explained above) shall make sure that 1/3 (to be rounded down in case of fractions³) or 2 persons (whichever is the lower) of the members of the supervisory body are independent.
 - A person will be considered “independent” in this context if (i) he/she does not have activities in any of the group entities (as a member of the management body, of a supervisory body or as an employee) to which the management company and the depositary belong and (ii) he/she is free of any business, family or other relationship with the management company or the investment company, the depositary and any other undertaking within the group that gives rise to a conflict of interest such as to impair their judgment.

The draft level 2 rules will enter into force 20 days after publication in the official journal of the EU which is expected to be at the end of Q1 2016 and will be directly binding 6 months after that date (i.e. around September 2016).

ESMA's updated Q&A for UCITS

ESMA has recently published an updated Q&A on UCITS, which grants a certain tolerance for UCITS to update their documentation, as follows:

New disclosure requirements	Deadline for compliance	
Update of the prospectus with remuneration and depositary-related disclosures under UCITS V	For a UCITS created before 18 March 2016	When the prospectus is updated for other purposes after 18 March 2016, and at the latest by 18 March 2017
	For UCITS created after 18 March 2016 ⁴	Immediately
Update of the KIID with remuneration-related disclosures under UCITS V	For a UCITS created before 18 March 2016	When the KIID is updated for other purposes after 18 March 2016, and at the latest by the next annual update (to be made within 35 day following 31 December 2016)
	For UCITS created after 18 March 2016 ⁴	Immediately
Update of the depositary agreement	For a UCITS created before 18 March 2016	By the time that the level 2 rules will come into force (around September 2016); to be noted that the liability provisions of UCITS V will apply and override the contract, if not updated. It is to be noted that, in Luxembourg, the CSSF Circular 14/587 applicable to depositaries of UCITS, which comes into force on 18 March 2016, anticipates many of the level 2 rules. The Circular will be amended upon entry into force of the level 2 rules; matters already covered in the level 2 rules will be removed from the Circular).
	For UCITS created after 18 March 2016 ⁴	Immediately
Update of the financial statements of the UCITS with remuneration-related disclosures under UCITS V	For UCITS with a financial year ending before 18 March 2016	Not required
	For UCITS with a financial year ending after 18 March 2016 but before the UCITS management company has completed its first annual performance period in which it has to comply with the UCITS V remuneration provisions ⁵	On a best efforts basis and to the extent possible, explaining the basis for any omission
	For UCITS with a financial year ending after the UCITS management company has completed its first annual performance period in which it has to comply with the UCITS V remuneration provisions	Disclosure compulsory

⁴ Our understanding of the CSSF's position.

⁵ The UK FCA has, subject to the final ESMA Guidelines on Remuneration, indicated on 2 February 2016 (final policy statement (PS16/2)) that the UCITS V remuneration provisions will apply to a UK management company of UCITS as from the start of the first full annual performance period following 18 March 2016. Should CSSF follow this position from the FCA, it means that, in case of a Luxembourg management company with a financial year corresponding to the calendar year, the "first annual performance period" will start on 1 January 2017 and end on 31 December 2017.

Remuneration provisions to be clarified in level 3 guidelines

Finally, the remuneration provisions in the UCITS V Directive will be clarified in ESMA guidelines (i.e. in level 3 rules – below the “Guidelines”); these Guidelines are still expected and should apply only as from 1 January 2017⁶.

The CSSF however expects management companies to update their remuneration policies – or at least publish a summary of it on their website - as soon as possible after 18 March 2016⁶. Remuneration policies will consequently require a further (and potentially more substantial) update by end 2016, for compliance with the Guidelines.

As indicated in footnote number 5, the FCA took a similar approach as under the AIFM Directive, that the UCITS V remuneration provisions will apply to a UK management company only as from the start of the first full annual performance period following 18 March 2016. Such position from the FCA being subject to any contrary statement in the final Guidelines.

Should the CSSF follow this position from the FCA (very likely if confirmed by the Guidelines), it means that, in the case of a Luxembourg management company with a financial year corresponding to the calendar year, the UCITS V remuneration provisions would only apply as from 1 January 2017.

Furthermore, the EBA has published on 22 December 2015 final Guidelines on remuneration principles which apply to EU banks. They clearly state that the CRD remuneration provisions (which includes the 100/200% cap on bonuses for Identified Staff) apply to management companies which are subsidiaries of EU banks. However, uncertainty remains on how National Regulators will choose to comply or not with the EBA Guidelines.

How we can help

- We identify the impacts of the UCITS V rules on your organisation and the related challenges.
- We conduct a UCITS V gap analysis to identify potential compliance gaps and define ad hoc solutions to close them.
- We assist for implementing those solutions.
- We provide you with the news that really matter to you, analysed in due time by our experts with our [3W Regulatory Watch service](#).

⁶ Our understanding of the CSSF's position.

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Let's talk

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