After the publication of the new CSSF Circular 14/587 on UCITS depositaries last week, it is now the European legislator’s turn to adopt new rules on UCITS depositaries. Indeed, the Council of the European Union has formally approved today the proposal for a directive of the European Parliament and of the Council 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 (the so-called UCITS V Directive, hereafter the “Directive”).

The Directive reflects lessons learned from a number of failures in the UCITS market which led to losses of assets by UCITS investors and aims at re-establishing investor confidence. As the AIFM Directive (the “AIFMD”) already aims at mitigating the negative consequences of such failures for investors of alternative investment funds, it became necessary to align both regimes and apply such protective rules to retail investors as quickly as possible.

The new framework aims at strengthening the protection of UCITS investors vis-à-vis the depositaries and the managers of the funds, through new sets of rules relating to the depositary functions, the remuneration policies as well as the administrative sanctions applying to UCITS managers when failing to comply with their obligations under the Directive.

What are the key elements of the Directive?

Depositary functions

The Directive adds national central banks to the categories of entities which can act as depositaries of UCITS funds. Only national central banks, credit institutions and regulated firms that comply with organisational and prudential rules of regulated investment firms and provide sufficient guarantees in terms of prudential regulation, capital requirements and custody infrastructure will be eligible as UCITS depositaries and will hold for safe-keeping the assets of the fund.
Directly inspired from the AIFMD, the Directive clearly sets out the role and duties of a UCITS depositary concerning financial instruments that can be held in custody, and other assets such as derivative instruments as well as cash. It also harmonises throughout Member States the depositary’s oversight functions and establishes conditions that govern any delegation of the depositary’s tasks to a sub-custodian.

The depositary’s liability has also been strengthened. In case of loss of the financial instruments of the UCITS held in custody, the depositary will be under a strict duty to return financial instruments of identical type or the corresponding amount to the UCITS, without any possibility of escaping such liability unless a force majeure event occurs. Furthermore, protection of the UCITS assets is enhanced in the event of the insolvency of the depositary or any third party located in the European Union to whom custody has been delegated through clear segregation rules.

Remuneration policies

The amendments relating to remuneration policies have been introduced in the Directive in order to promote sound and effective risk management and not encourage excessive risk-taking. It shall apply to the staff of management companies and third parties involved in managing UCITS by taking decisions that have a material impact on the risk profile of the UCITS and the management company. Transparency of the remuneration practices will be enhanced.

In this context, the Directive provides for a level of investor protection similar to the one contained in the AIFMD which is focused on professional investors.

Administrative sanctions

The financial crisis also revealed discrepancies in the approach of supervisors to the sanctioning of breaches of UCITS rules. The Directive therefore enhances the existing regime to ensure effective and harmonised administrative sanctions to managers of UCITS by introducing minimum administrative sanctioning powers that must be available to supervisors. It is anticipated that such a harmonised system of strengthened cooperation will improve the effective detection of breaches of UCITS rules.

The Directive will come into force 20 days after its official publication and Member States will then have 18 months to implement the Directive into national law.

Arendt can assist you in the implementation of the above set of rules, notably in:

- assessing the impact of this new piece of legislation on your business model and advising you on the best way to implement this new framework updating your UCITS depositary agreement and service level agreement;
- reviewing your remuneration policy and the remuneration rules applicable to your delegates;
- providing dedicated professional training sessions which adequately meet your specific needs through Arendt Institute.