Undertakings for the Collective Investment in Transferable Securities Directive V: Increased Protection for Investors.

Mohammed K. Alshaleel

Abstract

This article considers the impact of the European Union's new Undertakings for the Collective Investment in Transferable Securities Directive (UCITS V) on investor protections and the system's alignment with the EU's Alternative Investment Fund Managers Directive (AIMFD). It scrutinizes the historical development of the UCITS Directives, the pivotal role of the depositary in the UCITS fund industry and the key regulatory changes of UCITS V. It concludes that the UCITS V provides greater protection for investors and should encourage confidence in UCITS products.

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Mohammed K. Alshaleel[1]

1. Introduction

The Undertakings for Collective Investment in Transferable Securities (UCITS) are a harmonised European open-ended retail fund product, with 9 trillion mark net assets in 2015, which can be marketed internationally and within the European Union on a European passport basis.[2] As open-ended vehicles, investors can redeem their shares/units from the fund directly at any time. The UCITS funds are externally managed by a fund manager and depositary.[3] A UCITS depositary is an entity that is independent from the UCITS fund's investment manager and the UCITS fund.[4] The independence of a depositary is a crucial pillar of investor protection because the depositary essentially acts both as a supervisor of a UCITS fund and as a custodian over the fund's assets.[5] Due to their high level of investor protection, the UCITS funds are marketable internationally and may register in non-European countries, such as Hong Kong, Singapore, Taiwan, Bahrain and Peru.

The key role of the UCITS Directive is to harmonise national rules in terms of authorisation, structure, supervision, disclosure and business.[6] The UCITS legal framework offers an attractive combination of transparency and liquidity for investors. Despite its fundamental role, the UCITS rules concerning depositaries in the Directive have remained mainly unchanged since the original UCITS Directive came into being in 1985. By way of illustration, one key deficiency relates to depositaries, where there are diverging interpretations of their main functions and liabilities. The potential outcomes of these divergences came to the fore in the course of crises stemming from the Madoff fraud and the bankruptcy of Lehman Brothers. The 2008 Lehman Brothers bankruptcy, with around $639 billion in assets and $619 billion in debt, it was the largest in history. Lehman was the fourth-largest U.S. investment bank at the time of its

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[2] The European Fund and Asset Management Association, ' The EFAMA Investment Funds Industry Fact Sheet' (March 2015), available at http://www.efama.org/Pages/Net-UCITS-assets-reach-EUR-9-trillion-mark-for-the-first-time-in-March-2015.aspx, accessed at 6 July 2015.

[3] Parliament and Council Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) [2009] oj23/203L , Article 5.

[4] Ibid, Article 25.

[5] Ibid, Article 22.

[6] H Scott, *International Finance: Law and regulations* (2nd edn Sweet and Maxwell, London 2008) 181.

collapse.[7] Madoff was a fund manager who dipped into investor funds, and covered defaults in one investor's account by using other clients' accounts. He gradually built his notorious and gigantic Ponzi scheme, managing the fund for some 20 or so years.[8] The impacts of the Madoff scandal are not restricted to the US markets and the fraud has been particularly severe in some EU Member States.[9] One specific fund that acted as a feeder fund for Madoff recorded losses of around $ 1.4 billion because of Madoff investments that turned out to be fictitious.[10] The losses suffered by this feeder fund have brought the matter of depositary's liability to the fore.[11]

The circumstances of the Madoff case raised significant issues for UCITS, in terms of the depositary eligibility, duties of the depositary, the ability of a UCITS depositary to delegate its functions, the remuneration policies, and the sanctions regime. The UCITS V Directive (2014/91/EU) amends Directive 2009/65/EC (the 'UCITS IV Directive') on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) in relation to depositary functions, remuneration policies and sanctions.[12] This article examines the key amendments of the UCITS regime and their impacts on enhancing investors' protection. The first part of the article explores the history of the UCITS Directives (UCITS I to UCITS V) as a key to understand the UCITS objectives, developments and the need for recent amendments. The second part of the article considers the pivotal role of the depositary in the UCITS system. The last part of the article scrutinizes the key regulatory changes of UCITS V, taking a comparative approach with the EU Alternative Investment Fund Managers Directive where it is necessary.

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[7] See, D. Jones, *Understanding Central Banking: The New Era of Activism* (Routledge, New York 2014) xx introduction.

[8] See, E Arvedlund, *Madoff: The Man Who Stole $65 Billion* (Penguin, London 2009).

[9] European Commission, 'Commission Staff Working Document, Impact Assessment Accompanying. The Document 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'. SWD (2012) 185.

[10] N Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press, Oxford 2014) 244.

[11] European Commission, 'Commission Staff Working Document, Impact Assessment Accompanying. The Document 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'. SWD (2012) 185.

[12] The UCITS V was published in the Official Journal of the European Union on August 2014, and it came into force on 17 September 2014. The Member States have 18 months to transpose UCITS V into national law by 18 March 2016.

2. The Evolution of the UCITS Regulations.

There is no doubt that the Directive on Undertakings for Collective Investment in Transferable Securities is a successful European story. It was created around 30 years ago, and it now represents the investment fund regulatory framework in Europe. The different legal forms of collective investment schemes and various regulatory approaches taken by European countries, particularly with regards to the obligations and controls imposed on the undertakings failed to provide comparable protection for investors and distorted the completion conditions between undertakings for different Member States. The Members of the EEA found it necessary to create a semblance of uniformity.[13] On 20 December 1985, the Council issued a Directive on the coordination of regulations and laws regarding the Undertaking for Collective Investment Schemes in Transferable Securities (85/611/EEC).[14] This Directive was the original and first Directive "UCITS I".

The fundamental aim of the UCITS I was to harmonise and enhance investors' protection among the EEA Members.[15] It also aimed to ensure that the UCITS created in one Member State could be marketed in another.[16] However, UCITS I did not achieve the EU's objective of a single market for financial services in Europe. The reality contradicted the expectations. This was principally for the reason that the marketing rules in the different Member State resulted in difficulties to cross border marketing of the UCITS. In the 1990s, recommendations and proposals were put forward to amend the UCITS I and provide a more practical harmonization of regulations throughout the Member States. These proposals led to a draft UCITS II Directive. However, UCITS II was abandoned because it was deemed to be too ambitious and the Member States failed to reach an agreement on its purpose and scope.

After UCITS II was abandoned, the European Commission published proposals for UCITS III. UCITS III consisted of two Directives: the "Management Company" Directive and the "Product" Directive. These two Directives were adopted in 2001. The aim of the Management Directive was to adopt the concept of a "European Passport" with respect to the management companies similar to that which exists for other financial institutions, such as banks whereby an

[13] C. Turner, *International Funds: A Practical Guide to their establishment and operation* (Butterworth-Heinemann, Great Britain 2004) 188.
[14] Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) [1985] ojL 375/3.
[15] G. McCormack, 'OEICs and trusts: the changing face of English investment law' (2000) 21 Co Law2-13.
[16] D Schubauer, 'Inadequacy of the UCITS Directive in a Global Marketplace' (2002) 21 N.Y.L. Sch. J. Int'l & Comp. L323-338.

authorization order in the home country enables it to work in other Member States without the need for further authorization.[17] Applying the concept of European passport required the Directive to pay proper attention to the issues of investors' protection and the cooperation between authorities in Member States.

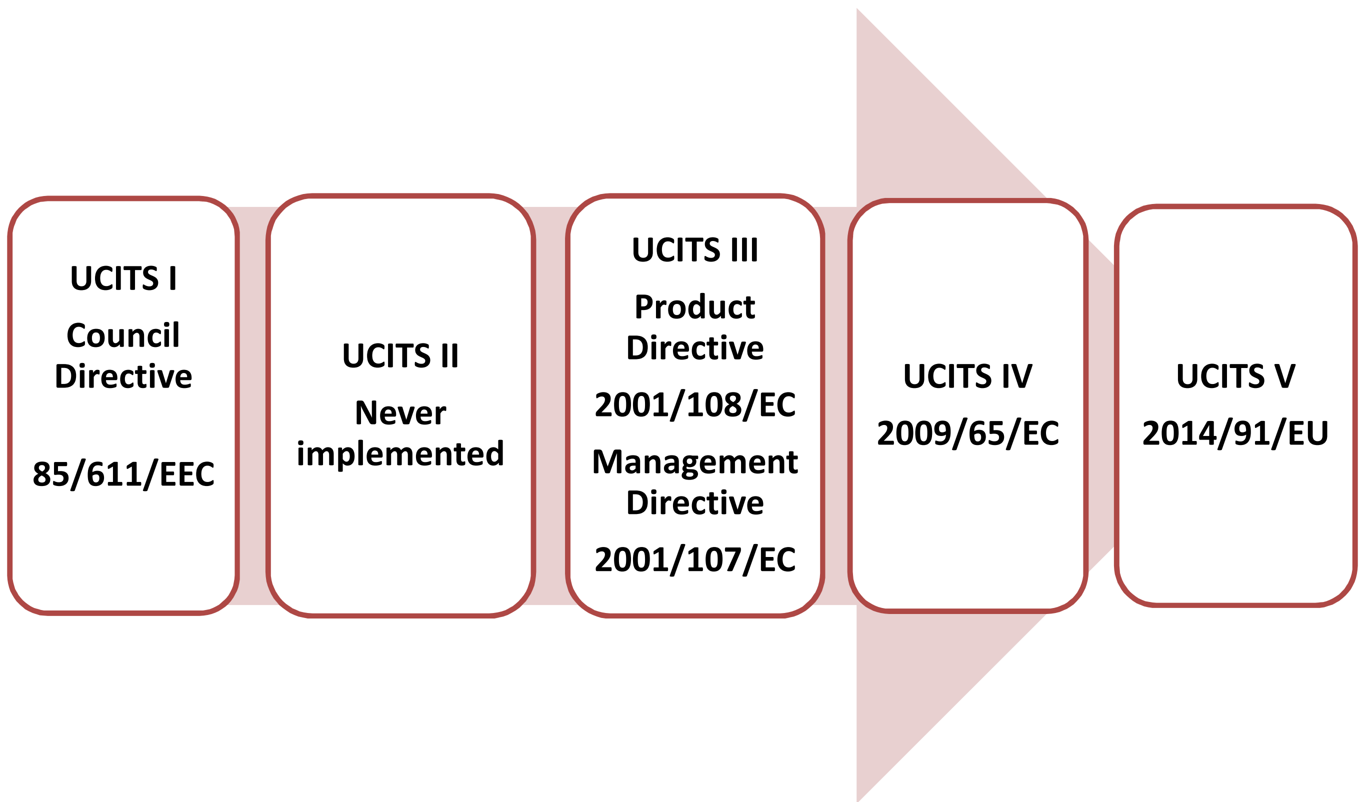
The Directive determined that the best way to ensure investors' protection was to impose various obligations on the management companies. The Directive gives a non-exhaustive list of functions that management companies can perform, such as investment, management, administration and marketing. Article 5d of the Management Directive provided that the home Member State of a management company is responsible for the supervision of management companies even when the management companies have established branches in other Member States.[18] In addition, Article 5f showed legislators' concern with ensuring investors' protection and avoiding fraud, which could cause losses to investors. The Article provides prudential rules that aim to minimize investors' risk.[19]

Directive 2001/108/EC was adopted together with the Management Directive and it is generally referred to as the "product" Directive.[20] The fundamental aim of the Directive was to remove barriers to cross border marketing of units of collective investment schemes by allowing them to invest in a wider range of financial instruments. This Directive was important because it allowed the possibility of establishing money market funds (which have become the dominant type of UCITS) index tracking fund, derivatives funds and fund of funds as UCITS.

In 2009, the European Council took another step toward achieving the single market dream by adopting the UCITS whose primary aim was to modernise the regulatory framework of the UCITS IV (figure 1).

[17] J Ernoult, W Hemetsberger, H Schoppmann and C Wengler, *European Banking and Financial Services Law* (3rd edn Larcier, Brussels 2008) 44.
[18] Parliament and Council Directive 2001/107/EC amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses [2002] ojL 41/20.
[19] Ibid, article 5f.
[20] Parliament and Council Directive 2001/108/EC amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS [2002] ojL 41/35.

Figure 1 The history of the UCITS Directive – From UCITS I to UCITS V

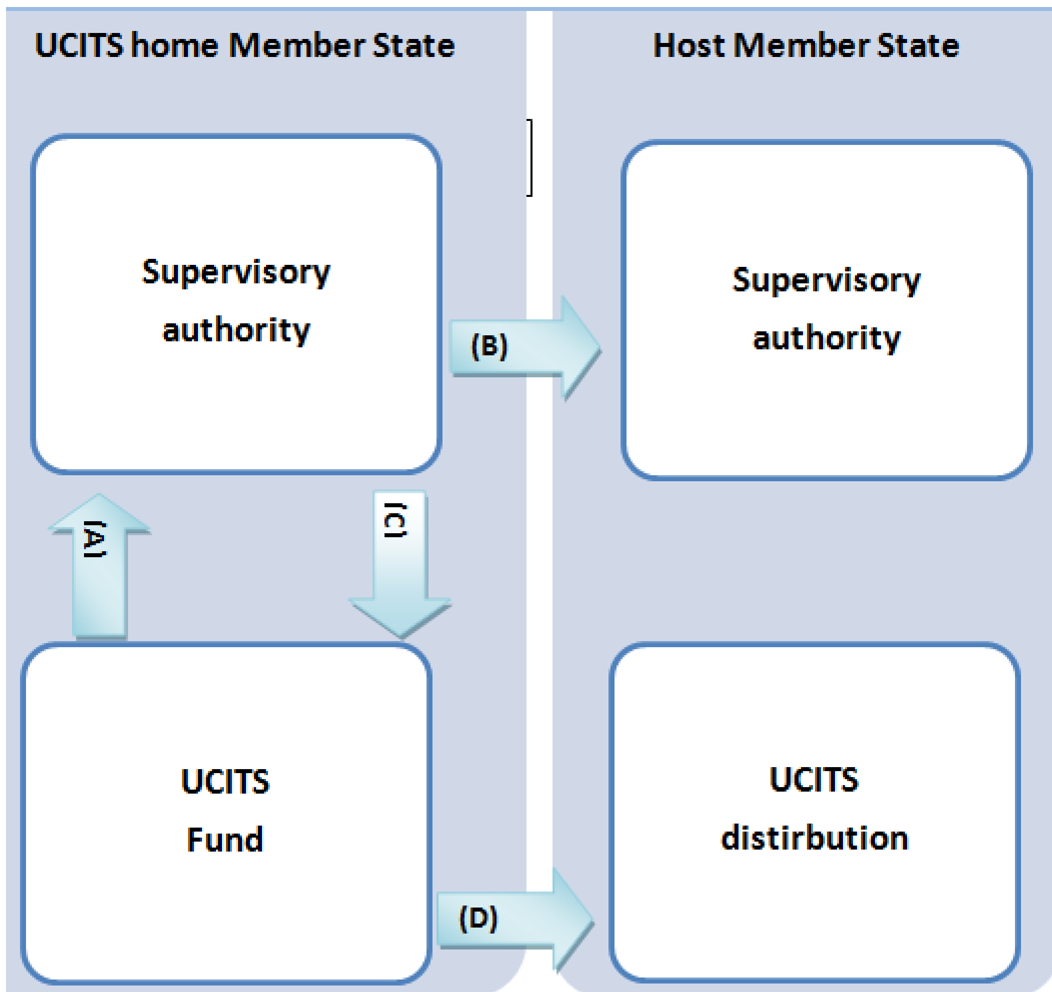


The UCITS IV Directive includes five core enhancements as explained below, namely, notification procedures, master- feeder structure, key investor information (KII), fund mergers and management company passport.

A- Notification procedures. The UCITS IV Directive aims to make the notification procedures accelerated and simple. The shares/units of a fund established in one EU Member State may be distributed to investors in another. In order to market the shares/units Member State (host State) a UCITS should provide a notification letter to its home Member State authorities together with specific documents. Then, the home Member State authorities will transmit this documentation within ten working days to host Member State authorities together with an attestation declaring that the UCITS meets all UCITS conditions.[21] After that, the UCITS will be permitted to market its shares/units in the host Member State starting on the date of the notification (figure 2).

[21] Parliament and Council Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) [2009] oj23/203L , article 93(3).

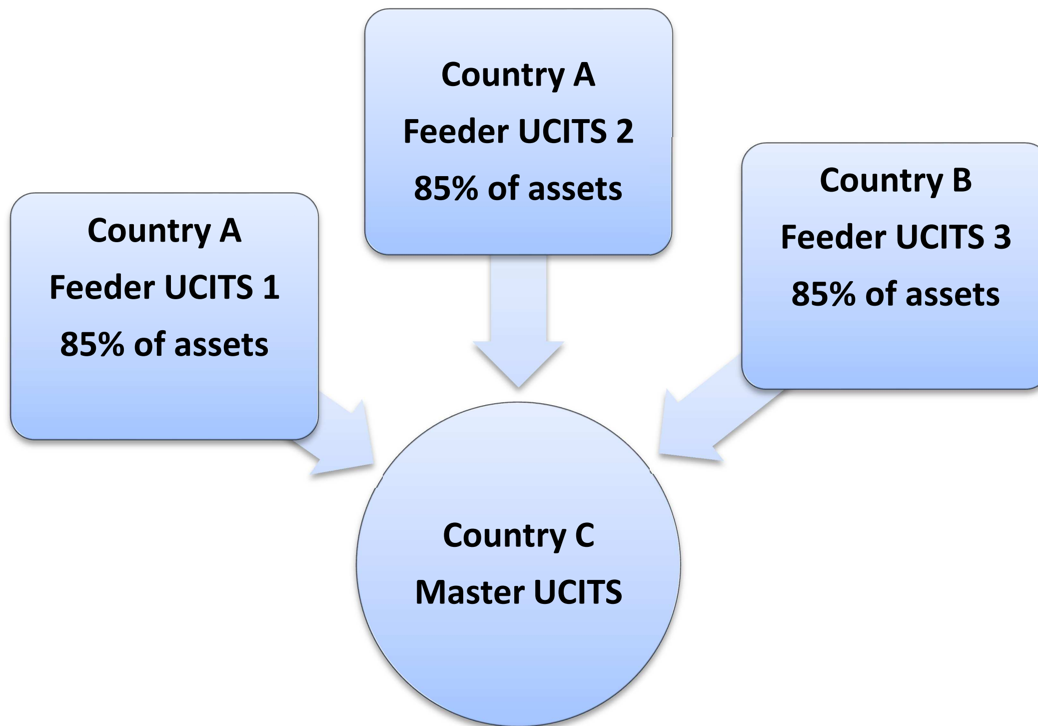
Figure 2 The Process of Notification Procedures



B- Master-feeder structure. The master-feeder structure provides that the feeder UCITS invests most of its assets in a master UCITS. This could be considered as the management of most of the assets of the feeder fund is being delegated to the manager of the master fund. Article 58 of the UCITS IV Directive stipulates that the feeder should invest at least 85% of its assets into a single master.[22] Further, the feeder may invest up to 15% in liquid assets and financial derivative instruments. The master and the feeder funds could be located in different Member States, but a master cannot be itself a feeder or invest its assets in a feeder (figure 3).

[22]Ibid, article 58.

Figure 3 The Master-Feeder Structure



C- Key investor information (KII). Disclosure is a significant element in the mutual funds industry. The UCITS introduces a new document "key investor information" (KII) for every UCITS, replacing the simplified prospectus. The key investor information must contain clear, fair and understandable information about specific issues of UCITS. It is clear that the KII must be brief and contain non-technical information.[23]

D- Fund mergers. The UCITS IV Directive introduces an effective regime for cross border as well as domestic mergers of UCITS. A merger may happen between one or more UCITS or sub funds (merging UCITS) and a receiving UCITS or sub fund (receiving UCITS).

E- Management company passport. This amendment is related to the authorization of the UCITS management company (which is different from the first amendment related to notification procedures for sale the units of UCITS funds in other EU member states). A UCITS management company that has obtained an authorization in its home Member State authority will be allowed to perform the activities for which it has been authorised in another Member State. Thus, the host State may not make the creation of a branch subject to any further authorization. However, the

[23] Ibid, article 78.

management company intending to perform activities in another Member State must notify the home State authority of its intention to do this and provide some additional information. The home authority will communicate the information received to the host Member State authority. The management company may then start business in the host State, providing cross border services subject to its home Member State's supervision.

Finally, on 28 August 2014, Directive 2014/91/EU, a Directive to amend Directive 2009/65/EC, was published in the Official Journal of the European Union. UCITS V entered into force on 17 September 2014. The core aim of the reform is to create uniform market conditions across the EU. The new rules are designed to essentially increase the level of protection enjoyed by UCITS investors. Those rules are also seen as a fundamental step towards restoring investor confidence in the wake of the financial crisis and scandals (UCITS V will be discussed in detail below).

3. The Pivotal Role of the Depositary in the UCITS Fund Industry.

Since the establishment of the regime for UCITS in 1985, depositaries have played a pivotal role in the European funds' industry. According to Directive 85/611/EEC (UCITS Directive), the appointment of a depositary is a condition for the approval of UCITS.[24] The depositary must be an institution in which investors can trust their assets will be kept safe.[25] Being an institution can also play a fundamental role in balancing the management company's prerogatives in order to ensure that investors' interests are at the core of the industry. UCITS depositaries are required to perform their functions with the highest professional skills and prudential standards. This is an essential requirement to obtain the high level of confidence that investors have always placed in the UCITS scheme.

In addition, since the main role of the depositary is to protect fund investors, it must act solely in the interests of the investors, so it is considered as a fiduciary.[26] The duties of the depositary in the UCITS governance system can be categorized into two key groups, namely safekeeping and monitoring. On the one hand, the depositary is responsible for the safekeeping of all of the UCITS property entrusted to it.[27] The depositary must take into its custody, or under its control, documents of title to the scheme property. The depositary is responsible for the collection of

[24] Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) [1985] ojL 375/3. Article 4.
[25] Ibid, Article 8.
[26] For further explanation regarding the fiduciary nature of the depositary see, A Hudson, *The Law on Investment Entities* (Sweet & Maxwell Limited, London 2000) 218.
[27] N Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge University Press, Cambridge 2010) 154.

income due to be paid for the account of the UCITS fund. On the other hand, the depositary is responsible for overseeing the fund manager activities. The depositary must take reasonable care to ensure that the fund is managed by the fund manager in accordance with the instruments of incorporation and the existing regulations.

4. Key Regulatory Changes Introduced by UCITS V.

As mentioned above, the UCITS V amends the existing UCITS IV regime. The key provisions of the UCITS V reflect the principal objectives of the new Directive, which is to strengthen and clarify the UCITS framework, especially in light of significant discrepancies in depositary duties and liabilities across the EU Member States demonstrated by the Madoff fraud and the Lehman Brothers default. Another important aim of the UCITS V is to align the UCITS regime with the EU Alternative Investment Fund Managers Directive (AIFMD) in order to harmonise and streamline EU funds regulations.[28] The UCITS V focuses on three key areas, namely: (i) clarification of the depositary role including a depositary's eligibility, its functions and its liability in circumstances where the assets in custody are lost; (ii) rules governing remuneration policies; and (iii) the harmonization of the minimum administrative sanctions regime across the EU Member States. The following discussion scrutinises each area in details.

4.1 Enhancing the Depositary Role.

The depositary office plays a significant role in sustaining a high level of investor confidence. It has been essentially important in winning investor acceptance for products domiciled in other EU Member States by building in a common structural protection against fraud or operational fault. Taking into consideration the increased complexity and heterogeneity of the existing funds, the function of the depositary becomes an even more significant control on the way in which the fund manager performs its business. The UCITS V enhances the following aspects of the depositary role:

1- Depositary eligibility criteria.

[28] An alternative investment fund is a 'collective investment undertaking' that is not subject to the UCITS regime, and includes hedge funds, private equity funds, retail investment funds, and real estate funds .Alternative investment funds invest in different types of global assets, including commodities and property. See, E Ferran, 'The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis' (2011) University of Cambridge Faculty of Law Research Paper No. 10/2011 ECGI - Law Working Paper No. 176/2011 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1762119 accessed 24 August 2015.

Article 8 (2) of the original UCITS Directive provided that a depositary must be an institution that is subject to public control.[29] In the UCITS IV, this provision was replaced by the following: "A depositary shall be an institution which is subject to prudential regulation and on-going supervision".[30] The main aim of the article is to restrict the categories of institutions that are eligible to act as a UCITS depositary. This provision provided the Member States with significant discretion to determine which categories of institutions shall be eligible to act as depositories. This led to legal uncertainty and inconsistency amongst Member States, which in turn led to different levels of investor protection. In order to address these concerns, UCITS V found it necessary to create an exhaustive list of entities eligible to act as depositaries, limiting the status to (i) a national central bank; (ii) a credit institution authorised in accordance with the CRD IV Directive (2013/36/EU); and (iii) another authorised legal entity, which is subject to capital adequacy requirements, not less than the requirements calculated depending on the selected approach under Article 315 or 317 of the Capital Requirements Regulation (Regulation 575/2013) (CRR). In addition, such an entity must not have own funds less than the amount of initial capital under Article 28(2) of the CRD IV Directive.[31] Restricting the eligibility of entities to work as depositaries to these three types provides UCITS investors with the same level of protection in all Members States.

To illustrate the evolving consistency, it is worth noting that according to Article 21 of the EU's AIFMD, the entities eligible to act as depositary shall be (i) a credit institution; (ii) an investment firm having its registered office in the Union, subject to capital adequacy requirements in accordance with Article 20(1) of Directive 2006/49/EC; and (iii) another category of institution that falls within the categories of institution determined by Member States to be eligible to be a depositary under Article 23(3) of Directive 2009/65/EC.[32] It is clear that the AIFMD cross-refer to Article 23(3) of the UCITS IV, which is amended by Article 22a of the UCITS V. That suggests that Article 22a should apply to the AIFM funds.

[29] Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) [1985] ojL 375/3. Article 8 (2).

[30] Parliament and Council Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) [2009] oj23/203L , article 23 (2).

[31] The European Parliament and the Council Directive 2014/91/EU on 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 [2014] ojL 257/186 Article 22 a.

[32] The European Parliament and the Council Directive 2011/61/EU on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2011] ojL 174/1, Article 21.

In addition, UCITS V affirms the principle of a single depositary function to which all assets of the fund must be entrusted. Requiring the UCITS funds to appoint a single depositary ensures that the depositary has an overview of all the assets of the fund and both the investors and the fund managers have a single point of reference in case problems arise in relation to the safekeeping of assets or the performance of oversight functions.

2- Depositary liability.

Under Article 24 of the UCITS IV Directive, the depositary is only liable to the UCITS and its unitholders for any loss suffered by them as a result of (i) its unjustifiable failure to perform its obligations or (ii) its improper performance of such duties. While this terminology has the advantage of being consistently used across EU jurisdictions, there has been an inconsistent interpretation of these two terms across Member States. This has led to different liability standards amongst Member States, meaning the UCITS unit-holders were provided with different levels of protection, undermining one of the main aims of the regulation. In order to harmonise the depositary liability across Member States, Article 22a(7) distinguishes between two types of assets. First, there are financial instruments that are capable of being held in custody, where the depositary will be liable for the loss of such assets 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."[33] Second, there are all other types of 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.

Regarding the first type of assets, if a financial instrument held in custody by the depositary itself or a sub-custodian is lost, a financial instrument of identical type or the corresponding amount should be returned to the UCITS without undue delay. The only way in which a UCITS depositary will be able to discharge this liability is if "it can prove that the loss was a result of an external event beyond reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary". If Article 22a(7) of the UCITS V is interpreted literally, it

[33] The European Parliament and the Council Directive 2014/91/EU on 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 [2014] ojL 257/186 Article 22a (7).

could be said that it does not impose strict liability on the depositary, meaning that acts occurring at the sub-custodian are external to the depositary.

In contrast, Article 21(13) of the AIFMD permits the depositary to discharge its liability where financial instruments held in custody by a third party are lost if it can prove that certain conditions are met, such as that there is a written contract between the depositary and the alternative investment fund which expressly allows the depositary to discharge its liability and establishes an objective reason to contract such a discharge. UCITS V does not give the depositary such permission to discharge its liability. Further, Article 21(14) of the AIFMD grants the depositary permission to discharge its liability where the law of a third country requires that certain financial instruments are held in custody by a local entity and there are no local entities that satisfy the delegation requirements found in the AIFMD. This is again provided that certain conditions are met. The UCITS does not contain an equivalent provision.

It is clear when compared to the AIFM depositary that the wording of UCITS V imposes stringent liability on the depositary. This means that the depositary does not escape any potential liability for loss by delegating some functions to sub-custodians. In fact, to ensure the best performance of its functions, the depositary might need to delegate to many unaffiliated sub-custodians over whom depositaries have no control or influence at all. Nonetheless, by imposing strict liability on the depositary for its own failures as well as for those of any sub-custodians that it appoints, the depositaries will be discouraged from using sub-custodians because it increases the risk on the depositary. That will have a negative impact on investing in other markets. Therefore, the UCITS regime should be aligned as much as possible with that of the AIFMD as it could result in maximizing competition in the funds industry.

3- Delegation of custody.

Since 2001, UCITS invest in an increasingly complex array of financial instruments such as money market instruments and index-based funds including exchange traded funds and in many markets outside of the EU.[34] With investment opportunities arising in different international markets, there is an increased need to appoint sub-custodians in these countries. Nonetheless, lessons from the Madoff and Lehman cases affirm that the use of local sub-custody networks can pose significant risks to a UCITS. In spite of the increase of eligible investment instruments, the UCITS IV Directive does not define the conditions applicable in case a depositary delegates

[34] Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:079:0011:0019:EN:PDF.

custody to a sub-custodian. Article 22a of the UCITS V defines the conditions a depositary must meet to be authorised to delegate its safekeeping functions to a sub custodian: (i) there should be an objective reason for the delegation and no intention to circumvent the Directive; (ii) the depositary should exercise all due skill, care and diligence in the selection and the appointment of any third party; and (iii) there should be periodic review and on-going monitoring of the delegatee.[35] Cash monitoring and oversight cannot be delegated.[36] These conditions are to a very large extent similar to the provisions specified in Article 21(11) of the AIFMD. Nevertheless, one additional condition has been included in Article 22a sub paragraph 3(d) requiring that "in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among or realization for the benefit of creditors of the third party". The main aim of this additional condition is to safeguard UCITS assets as far as possible from the effects of the insolvency of the sub-custodian.

It is clear that Article 22a is demanding and could possibly lead to situations where UCITS depositaries in some countries would not be able to meet these requirements. It will be challenging for the depositary to make a decision with 100 percent certainty ahead of appointing a sub-custodian how the insolvency laws in the jurisdiction of that delegate might apply. That might ultimately exclude UCITS from investing in specific jurisdictions. In circumstances where the appointment of a sub-custodian is required under local law, the depositary "may" appoint a local entity that does not satisfy the delegation requirements set out in UCITS V provided that investors are informed of the circumstances of the delegation, that the delegation is required due to local legal constraints in the third country, and "of the risks involved in such delegation".[37]

4.2 Manager Remuneration.

Remuneration of UCITS managers is generally based on the net assets value (NAV) based fee.[38] This means that there is a benefit for managers to increase risk in order to increase potential returns.[39] Under UCITS IV, there were no requirements with respect to the remuneration of

[35] The European Parliament and the Council Directive 2014/91/EU on 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 [2014] ojL 257/186 Article 22a, 3 (b).
[36] Ibid, 22a, 1.
[37] Ibid, 22a, 3.
[38] The per unit net asset value of a UCITS is the aggregate value of the fund assets minus the aggregate liabilities of the fund divided by the number of units outstanding.
[39] The Alternative Investment Management Association, 'UCITS V – Set Ratio of Fixed to Variable Remuneration

UCITS management companies. The remuneration structures were rarely disclosed in the UCITS offering documents, making managers generally unaccountable to the fund's unitholders. UCITS V introduces an express obligation on management companies to establish and apply remuneration policies and practices that are consistent with and promote sound and effective risk management.[40] Further, 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.

In fact, the new UCITS remuneration provisions has its origins in provisions within Capital Requirements Directive III (CRD III) and the AIFMD, which is based on the Financial Stability Board's (FSB) Principles and further Implementation Standards for Sound Compensation Practices, which were approved by Group of Twenty (the G20). The CRD III amendments and the FSB's Principles were a necessary response to the financial crisis. The Financial Stability Board's Principles were "intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms". However, they do not apply to the UCITS.[41]

When the UCITS managers establish remuneration policies, they are expected to comply with the specific principles in a way and to an extent that is appropriate to their size, internal structure and the nature, scope and complexity of their activities.[42] For instance, the remuneration policy should be in line with the business strategy, objectives, values and interests of the management company and the UCITS. The remuneration policy should, at least annually, be subject to central and independent internal review for compliance with policies and procedures. Overall, the new remuneration rules aim to provide investors with a high level of protection. The new rules aim not only to place the remuneration polices under the oversight of the depositary but also under the oversight of the competent authorities. In this regard, the European Securities and Markets

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and Performance Fees' (2013) available at http://www.aima.org/objects_store/ucits_v_fixed_variable_remuneration_-_position_paper_may_2013_.pdf accessed 8 August 2015.

[40] The European Parliament and the Council Directive 2014/91/EU on 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 [2014] ojL 257/186 Article 14a.

[41] The Alternative Investment Management Association' 'AIMA Position Paper UCITS V' (2012) available at http://www.aima.org/objects_store/ucits_v_-_position_paper.pdf accessed 8 August 2015.

[42] The remuneration requirements will apply to delegates performing investment management functions.

Authority (ESMA) has the right to request information from competent authorities on the remuneration policies and practices referred to in Article 14a of this Directive.[43]

4.3 Sanctions Regime.

One of the fundamental amendments made to the UCITS IV is the sanctions regime.[44] The UCITS IV Directive includes broad principles regarding the investigation and supervision powers given to the competent authorities of the Member States, but these general rules lead to inconsistency between Member States which might take different forms. For example, the Member States could impose different fines for the same class of breaches or might apply different criteria to determine the amount of administrative sanctions.[45] In order to address this inconsistency, UCITS V seeks to harmonise across member states the administrative penalties in respect of infringements of national provisions. It seeks to achieve that through (i) establishing a list of minimum types of administrative penalties and administrative measures that may be applied in the event of any infringement of the UCITS Directive; and (ii) setting out prescriptive criteria that should be taken into account when determining the type and level of administrative sanctions to impose. Furthermore, Article 99a of the UCITS V requires that breaches of the key investor protection safeguards in the UCITS Directive be subject to penalties. These include breaches related to performing the activities of UCITS without obtaining authorization, carrying out the business of a management company without obtaining prior authorization and obtaining authorization order through false statements. The administrative penalties and other administrative measures that may be applied should include at least one of the following (1) a public statement which identifies the person responsible and the nature of the breach; (2) an order requiring the person responsible to cease the conduct and to desist from a repetition of that conduct; (3) suspension or withdrawal of the authorization of the UCITS or the management company; (4) a temporary or a permanent ban against a member of the management body of the management company or investment company and; (5) pecuniary penalties.

At the cooperation level, UCITS V requires the Member States and the European Securities and Markets Authority (ESMA) to establish communication channels to report infringements of the

[43] The European Parliament and the Council Directive 2014/91/EU on 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 [2014] ojL 257/186, Article 14b (2).

[44] Ibid, Chapter XII.

[45] For example, for legal persons, the maximum fines foreseen for offences range from €100.000 in one Member State30 to €10 million in another. See German Investment Law or Investmentgesetz (InvG), section 143, paragraph (5).

UCITS Directive. The Directive also requires them to provide for whistle-blower protection “at least against retaliation, discrimination and other types of unfair treatment"[46] And to report each year to ESMA aggregated information on measures and sanctions imposed, and to inform ESMA of any individual measures and sanctions they have published.[47]

5. Conclusion

The new UCITS V Directive is a positive development that reflects lessons learned from a number of failures in the UCITS market that have resulted in losses of assets by UCITS investors. It borrows ideas from the AIFMD concerning protection and procedures for investor protection and extends this protection to the UCITS retail investors. However, UCITS V imposes stringent liability on the depositary for its own failures as well as for those of any sub-custodians that it appoints. That will have a negative impact on investing in other markets. Therefore, the UCITS regime should be aligned as much as possible with that of the AIFMD which could result in maximizing competition in the funds industry. The UCITS V Directive harmonizes the rules on the functions of the depositary, sets conditions that should be applied when delegating these functions to third parties, and imposes liability of depositaries in an effort to strengthen investments and increase confidence in the UCITS industry. It goes further and grants the Member States discretion relating to measures and penalties that should be imposed following infringements of the Directive. The stricter rules on depository’s functions work to ensure fraudulent schemes are minimised in Europe. The UCITS framework is largely regarded as a standard for fund regulation universally, and it is crucial to maintain this. The UCITS V is a significant achievement and will have great impacts on investors throughout Europe. At least in conception retail investors in Europe should enjoy greater security.

Member States should adopt and publish any laws, regulations and administrative provisions necessary to comply with this Directive by 18 March 2016. Therefore, management companies, investment companies and depositories should prepare for the adoption of these new rules. This includes assessing the impact of the new depositary eligibility, delegation and liability provisions. Particularly, sub-custody arrangements should be reviewed to determine whether changes are required to the existing process. The Directive also requires UCITS managers to

[46] The European Parliament and the Council Directive 2014/91/EU on 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 [2014] ojL 257/186 Article 99d.

[47] Ibid, Article 99e.

review their existing remuneration policies in order to determine which employment contracts may be impacted.