Title: Consultation on the Transposition of the Recast Undertakings for Collective Investments in Transferable Securities (UCITS V) Directive **IA No:** **Lead department or agency:** HM Treasury **Other departments or agencies:** Financial Conduct Authority	**Impact Assessment (IA)** **Date:** 16/07/2015 **Stage:** Consultation **Source of intervention:** EU **Type of measure:** Secondary legislation **Contact for enquiries:** Sussie Moran - 0207 270 1983

Summary: Intervention and Options

RPC Opinion: Awaiting Scrutiny

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, Two-Out?**	**Measure qualifies as**
See text	See text	See text	No	NA

What is the problem under consideration? Why is government intervention necessary?

The UK is required to implement the amended EU Directive Undertakings for Collective Investments in Transferable Securities Directive (UCITS V) (2014/91/EU) by 18 March 2016. UCITS V sets common EU regulatory standards relating to UCITS investment funds that Members States are required to meet, requiring the UK Government to make changes to its existing law and regulations for UCITS funds. The proposed changes to the UCITS regime have been prompted by the financial crisis and the response of governments internationally to secure stable financial markets. The amendments in UCITS V specifically deal with depositary functions, remuneration policies and sanctions for failure to comply with the Directive.

What are the policy objectives and the intended effects?

The amendments brought by the UCITS V Directive will raise standards of protection for EU UCITS investors. In particular, the strengthening and harmonisation of the UCITS depositary regime means clients' assets will be better protected. HM Treasury's policy objective is to achieve compliance with the UCITS V Directive while keeping to a minimum the impact on the UK investment management sector. The Directive is expected to have some limited impact on industry. Many of the requirements under UCITS V will be familiar to impacted firms as they are similar to those implemented under existing legislation. UCITS V aims to bring in to line those Member States without firm rules on depositories, remuneration and sanctions.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Option 1. Amend existing UK law and regulatory rules to ensure they meet the requirements of EU law, working alongside what is already in place and ensuring transposing measures do not go further than the Directive's requirements (i.e. avoiding gold-plating);
Option 2. Do nothing and fail to transpose the UCITS V Directive.

Option 2 has been discounted as this is an EU Directive and the UK has a treaty obligation to transpose it into national law. Option 1 is preferred as there is little flexibility in how UCITS V should be implemented, and other than ensuring minimum harmonisation, HM Treasury has made no substantive policy choices in drawing up draft legislation for consultation. Option 1 has the benefit of working alongside the existing regulatory system designed to meet the requirements of the UK investment market.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 03/2021

Does implementation go beyond minimum EU requirements?			No		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: ..... Date: .....

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low:	**High:**	**Best Estimate:**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional		Optional	**Optional**
High	40,860,000		Optional	**Optional**
Best Estimate	40,860,000		See text	**See text**

Description and scale of key monetised costs by 'main affected groups'

The best estimate at pre-consultation stage is obtained by totalling the estimated costs incurred by implementing the depositaries and remuneration provisions. While it is our best estimate, HMT expect this estimate to be at the higher end of the costs to industry scale. Please see text for details on limited cost estimates at the pre-consultation stage. HMT will seek to gather evidence on costs during the consultation and will provide further detail in the final stage impact assessment.

Other key non-monetised costs by 'main affected groups'

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

No monetised benefits at this stage. HMT will gather evidence on monetised benefits during consultation to include in the final stage impact assessment.

Other key non-monetised benefits by 'main affected groups'

There are a number of non-monetised benefits by implementing the UCITS V Directive. These broadly fall under enhancing consumer protection and financial stability. The EU UCITS regime has developed into a respected international brand ensuring a high degree of investor protection. The UCITS V changes will improve the UCITS brand and provide significant benefits to both the industry and investors.

Key assumptions/sensitivities/risks **Discount rate**

HMT will consult on key risks and assumptions during consultation stage. The main assumptions surround the ability of the changes to depositaries and remuneration policies in promoting financial stability and decreasing risk associated with UCITS funds.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs: See text	**Benefits:** See text	**Net:** See text	No	NA

Evidence Base (for summary sheets)

Background.

UCITS stands for Undertakings for Collective Investments in Transferable Securities. UCITS are a type of regulated investment fund. The existing UCITS Directive sets out common rules for this type of investment fund (including rules on investment policy, risk management and investor disclosure). Funds which meet these rules may be marketed across the EU based on home state authorisation.

The original UCITS Directive was adopted in 1985 and aimed to offer greater business and investment opportunities for both industry and investors by integrating the EU market for investment funds. The UCITS Directive sets out a harmonised regulatory framework for investment funds that invest in certain classes of assets, providing high levels of investor protection and a basis for the cross-border sale of these funds.

The UCITS Directive has been key to the development of the European investment fund industry. The UCITS brand is recognised worldwide and, due to its regulated status and emphasis on investor protection, over 70 non-EU jurisdictions permit the distribution of UCITS products into their markets – making UCITS a global benchmark and genuine marketing success story. At the end of March 2015 the assets under management of UCITS funds globally were over EUR 8.277 trillion, representing 65% of all investment fund assets in Europe (source: EFAMA Quarterly Statistical Release, No. 61). In the UK, there are currently c.150 authorised management companies in the UK and 11 authorised depositaries of UCITS funds. Depositaries are responsible for the safekeeping of the assets of a UCITS fund and monitoring many of its activities.

In July 2009 the European Commission launched a wide-ranging public consultation on the UCITS depositary function. The objective of the consultation paper was to gather evidence in order to clarify and strengthen the regulation and supervision of UCITS depositaries (among other operational aspects of UCITS funds), with a view to consolidate the level of protection of UCITS investors, further strengthen the UCITS brand, and attract investment. Submissions to the consultation paper suggested reforms in the areas of fund depositaries, remuneration, and national sanction regimes.

Following the consultation, the European Commission formally proposed a reform of the UCITS Directive, commonly referred to as UCITS V. There have been three previous amendments to the UCITS Directive since its introduction. UCITS V amends the previous version of the UCITS Directive, known as UCITS IV, which came into force in the UK in July 2011.

UCITS V is an EU Directive and the UK has a treaty obligation to transpose it into national law by 18 March 2016. UCITS V is a minimum harmonising directive, which means the UK has discretion to impose stricter standards. In the case of administrative sanctions, our existing legislation and rules already give effect to the directive requirements, and in some cases go further. In relation to the remainder of the provisions, we have decided (wherever possible) not to go beyond the minimum requirements imposed by the directive.

Interaction with relevant EU funds legislation

The two primary European Directives that directly set the framework for collective investment schemes in the UK are the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD):

- The UCITS Directive sets out requirements for collective investment schemes that are established and located in the EU and suitable for retail investors.
- AIFMD, which came into force on 22 July 2013, regulates the managers (Alternative Investment Fund Managers – 'AIFMs') of Alternative Investment Funds (AIFs), which are generally addressed to professional investors. It is also possible in the UK to have a retail scheme which does not fall within the UCITS regime, referred to as a non-UCITS retail scheme, or NURS. A NURS will constitute an AIF for the purposes of the AIFMD.

So funds in the UK are, broadly speaking, either UCITS or AIFs and are regulated separately under either the UCITS Directive or AIFMD. Many of the proposals in UCITS V on depositaries and on remuneration bring UCITS into line with AIFMD. This means that UK firms subject to the AIFMD are already complying with requirements which are broadly comparable with the rules laid out in UCITS V and/or they are familiar with the requirements, which should ease implementation. However, certain requirements are new and/or go beyond those set out in AIFMD, which will require firms to incur costs. The costs and benefits of these measures are discussed in more detail below.

Further, the requirements for minimum national sanctions under UCITS V are already in place under the provisions set out in the Financial Services and Markets Act 2000 (FSMA). Thus, we do not expect firms to have to make any changes or incur any additional costs or benefits as a result of these measures.

The UK's approach to implementing the UCITS V Directive.

HM Treasury and the FCA will be consulting separately on the implementation of the UCITS V Directive. In terms of division of implementation duties, HM Treasury will be responsible for the parts of the UCITS V Directive that are more structural in nature. HM Treasury's statutory instrument will contain provisions to transpose the directive requirements as to depositary liability for loss of financial instruments, obligations on the FCA as regards sharing of information and reporting of infringements, publication of penalties for contravention of the directive and certain miscellaneous provisions. HM Treasury will also be working on the requirements relating to protection of UCITS assets in the case of depositary insolvency. Where applicable, the statutory instrument will update FSMA and relevant secondary legislation to put into effect the directive requirements alongside the existing domestic framework.

Where possible HM Treasury will seek to minimise the impact on industry while implementing the Directive in full.

The Financial Conduct Authority (FCA) will be responsible for implementing the majority of the rules which will directly impact consumers and industry. This includes the parts of the Directive that are more technical in nature and which require changes or additions to FCA rules, including:

- The general obligations applicable to the depositary;
- The duties of the depositary in dealing with potential conflicts of interest;
- The obligation of the management company to appoint a single depositary;
- The eligibility criteria to act as a depositary, for firms that are neither national central banks nor credit institutions;
- The cash monitoring, safekeeping and oversight functions of the depositary;
- Delegation of the safekeeping function;
- Reuse of the assets of the UCITS by the depositary;
- Remuneration requirements applicable to the management company;
- Disclosure requirements (changes in the information to be included in the prospectus, annual report and Key Investor Information Document (KIID)); and
- Whistleblowing requirements applicable to the depositary and the management company.

The FCA are proposing to transpose the requirements by adopting an 'intelligent copy-out approach', whereby they are adhering to the wording of the UCITS V Directive as closely as possible when drafting the relevant provisions in the FCA handbook and are not, as far as possible, going beyond the requirements of the directive or 'gold-plating'. This is consistent with the approach taken when transposing the AIFMD. Please see the relevant sections of this Impact Assessment for a discussion of implementation approaches for the depositary, remuneration and national sanction regime provisions.

The Directive allows a management company that has appointed before 18 March 2016 a depositary that does not meet the new requirements under UCITS V, to retain the services of such depositary until 18 March 2018. The FCA will transpose this transitional provision into their rules. The FCA will also propose to allow for an additional transition period that will allow firms to comply with the remuneration requirements starting from the first full performance period commencing after 18 March 2016. There will also be a transitional period for management companies to comply with some of the disclosure

requirements and for depositaries to comply with the proposed new capital resources requirements. This has the aim of easing the implementation process for industry.

Under the UCITS V Directive, the European Commission is empowered to adopt delegated acts (commonly referred to as the Level 2 measures), which will set out most of the detailed requirements that fund management firms and depositaries will need to comply with. At the time of writing this Impact Assessment, the Level 2 measures have not been set. The Level 2 measures under UCITS V will set out the independence requirements between the management company and the depositary, as well as the steps to be taken by any third-party delegated custodian to protect the assets of the UCITS in case of insolvency. HMT has taken the decision to produce the consultation impact assessment without the Level 2 measures as there is no indication of when the measures will be set. It is also unlikely that the Level 2 measures will have an impact on the aspects of the Directive that are being implemented by HMT. By waiting for the Level 2 measures to be set before going to consultation, we would run the risk of not being able to implement the Directive by the deadline of 18 March 2016. The level 2 measures cover most of the operational requirements applicable to depositaries, in particular, details of:

- what should be covered in the contract between the management company and the depositary;
- safekeeping, oversight and cash monitoring requirements;
- liability for losses of financial instruments and of the cases in which such liability could be discharged; and
- due diligence requirements applicable to depositaries and of the segregation requirements when the safekeeping function has been delegated.

Problem under consideration and rationale for change

Following the financial crisis, the European Commission concluded that the UCITS Directive was no longer sufficient to safeguard and support the European fund industry and the needs of European investors. Core elements of the Directive did not function effectively. In particular, concerns had been raised around existing regimes for depositaries, remuneration and sanctions, as set out below.

Depositaries.

For investor safety, UCITS assets are held by a separate company known as a depositary, which also checks the fund manager's activities (e.g. whether they properly follow the fund's investment strategy). A UCITS depositary is an entity that is independent from the UCITS fund and the UCITS fund's investment manager. The independence of a depositary is necessary because the depositary essentially acts both as a supervisor of a UCITS fund (overseeing certain fund transactions such as subscriptions and redemptions) and as a custodian over the fund's assets. While the fund manager makes investment decisions for the fund, the depositary is in charge of holding the fund's assets in custody on behalf of investors. The assets of the UCITS are segregated from the assets of both the depositary and the manager. Therefore, the UCITS assets are protected in case of a default by the manager or the depositary. This is a crucial pillar of investor protection in the UCITS framework.

In addition, while the safekeeping of investors' assets is a core task of the depositary, the depositary also performs certain oversight functions. These functions include:

- Verifying that a UCITS fund's sales, repurchase and redemption of units or shares is carried out in accordance with applicable laws;
- Verifying that the net asset value of units is calculated in line with national laws and fund rules; and
- Ensuring that transactions of the fund manager comply with all applicable laws and that transactions involving the fund's assets are carried out within the relevant time periods.

UCITS provisions on depositaries have remained unchanged since the UCITS Directive first came into force in 1985. Since then, however, the investment environment for UCITS has evolved; fund portfolios are increasingly diverse and international, they are often complex and can be held in custody outside the EU (for example, in emerging markets).

Previous UCITS Directives only set out high-level requirements on the depositary and its liability towards investors when things go wrong. However, events such as the Madoff fraud, where investors incurred huge losses due in part to failures of the depositary function in certain jurisdictions, have shown that these requirements have been interpreted differently across Europe, so investors do not always have the same standards of protection. Such cases highlighted that there can be serious consequences if there are no adequate measures in place to prevent conflict of interest issues when allowing a company to act as both fund manager and depositary. Similar problems could arise when delegating these roles to the same third party or sub-custodian. The following concerns were identified:

- UCITS are aimed at retail investors and should offer the highest level of investor protection. At present, however, the regime governing depositaries of UCITS is not only less stringent than that which applies to AIFs under AIFMD, but the UCITS depositary rules are also applied unevenly across Europe. Ensuring that consumers' assets are safeguarded by depositaries that meet minimum standards in terms of prudential regulation, capital requirements and effective supervision is a core objective of the UCITS V Directive. It is also crucial that a UCITS depositary is able to fulfil its duties. UCITS V seeks to address these issues by requiring the appointment of a single, independent depositary to each UCITS fund so the depositary has clear oversight across the UCITS assets. To ensure depositaries are sufficiently robust, UCITS V includes specific requirements as to who can be appointed as a depositary and that the appointment of a depositary must be evidenced by a written contract, confirming minimum standards of operation.
- As the European Commission highlighted in its Impact Assessment on the Directive, holding assets through sub-custodians has become increasingly common, and under the current regime it is unclear what duties a depositary has in the selection and supervision of the sub-custodian. It is therefore legally uncertain across the EU as to what extent a depositary is liable for losses at the sub-custodian level. UCITS V therefore sets out rules on how and when depositaries can delegate activities to third parties, and specifies that delegation of activities does not mean they can pass on their responsibilities to others.
- The European Commission's UCITS V impact assessment concluded that a 'strict liability' standard that obligates depositaries to return instruments lost in custody irrespective of fault or negligence is both conducive to ensuring a high level of investor protection and to achieving a uniform standard across the EU.

Prior to the amendments in UCITS V, the existing UCITS Directive did not contain any rules to cover these issues. Harmonising these rules will benefit retail investors by reducing uncertainty and ensuring they can continue to trust UCITS, whether marketed across borders or not.

Remuneration.

The European Commission also highlighted issues surrounding the remuneration of fund managers and institutions. The fallout from the financial crisis demonstrated that in some cases, remuneration and performance incentive schemes in financial institutions exacerbated the impact and scale of the crisis by contributing to decision making in the short term without acknowledging potential long term repercussions of those decisions. This increased the incentive for taking excessive risk.

UCITS V seeks to introduce measures that align the incentives of managers and investors. UCITS V aims to make management companies of UCITS subject to remuneration requirements which are broadly in line with those applicable to managers under AIFMD.

Sanctions.

Lack of enforcement of EU rules in one Member State may have significant implications for the stability and functioning of the financial system in another Member State. It is therefore necessary to ensure a consistent and effective application of EU rules in all Member States – this in turn requires supervisors to be able to deploy sanctioning regimes that are sufficiently convergent and strict, so as to act as a deterrence.

Following the crisis, the European Commission and the Committees of Supervisors (now the European Supervisory Authorities) carried out analysis of national sanctioning regimes. The analysis found a number of weaknesses throughout existing systems that may impact the application of EU legislation.

Compromised effectiveness of financial supervision may ultimately affect competition, stability and integrity of financial markets and consumer protection. The European Commission therefore suggested putting in place common minimum standards in its Communication of 9 December 2010: 'Reinforcing sanctioning regimes in the financial sector'. These proposals reinforce and standardise the approach to national sanctioning regimes. The common minimum standards have been included throughout recent EU legislative proposals that include the Capital Requirements Directive IV, Markets in Financial Instruments Directive, the Market Abuse Regulation, and Transparency Directive. They are therefore also applied in UCITS V, which will help to standardise sanctions applied across the sector. As the level of the sanctions are already enforced in other financial services legislation, it is expected that the sanctions laid out under UCITS V will have minimal impact on UK industry, as many firms will already be subject to the existing domestic sanctions laid out in FSMA and by the FCA. The policy objectives and implications of the National Sanction Regime provisions laid out under UCITS V are discussed later in this impact assessment.

(For further discussion, see the Commission's Impact Assessment: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012SC0185&from=EN, pp. 5-7).

Policy Proposals.

UCITS V introduces a number of targeted reforms to the UCITS Directive with the objective of updating the legislative framework to ensure the safeguarding of UCITS fund operations across the EU, to lower risk surrounding the management of UCITS funds, and to build consumer protection and trust in the market. Overall, this will further improve the reputation of UCITS as a global brand that is highly attractive to investors.

HM Treasury's priority when implementing the UCITS V Directive is to ensure that these high-level objectives are delivered whilst avoiding 'gold-plating' and ensuring that UCITS V has minimal impact on industry. Where the FCA is responsible for implementing the requirements under the Directive, they have taken an 'intelligent copy-out' approach, whereby they are seeking to implement the Directive in full without going further than that the Directive text wherever possible.

The policy objectives and their intended effects for each of these key areas are discussed in detail below.

Depositaries.

The policy proposals for each of the key areas of depositaries provisions are as follows:

1. Eligibility to Act as a Depositary.

UCITS V introduces an exhaustive list of entities eligible to act as a depositary of a UCITS fund. This aims to strengthen consumer protection by ensuring that only institutions that comply with specific safeguards can provide the depositary function. The UCITS V impact assessment executed by the European Commission concludes that 'both credit institutions and regulated investment firms provide sufficient guarantees in terms of prudential regulation, capital requirements and effective supervision to act as UCITS depositaries'. As most UCITS depositaries in the UK are already credit institutions or regulated investment firms, the impact of the UCITS V policy is expected to have minimal impact on UK industry.

Of the 11 UK depositaries, there are currently 3 non-bank depositaries that are already subject to specific capital resources requirements laid out in the FCA handbook, which go beyond the level of requirements under UCITS V. The FCA are responsible for the implementation of these provisions and propose to retain the current level of capital requirements as they bring into line non-bank requirements with the requirements for bank depositaries and offer a better level of investor protection.

In addition, to ensure UCITS V depositary requirements are met, UCITS V also specifies that the appointment of a depositary shall be evidenced by a written contract and that depositaries must have a

uniform list of oversight duties established in contractual form. Currently, the oversight function performed by depositaries is uneven across the EU. Ensuring fund managers are performing their role appropriately provides an important level of consumer protection, so introducing harmonised minimum standards will guard against investor detriment. These provisions will require firms to reissue contracts in a similar fashion to AIFMD.

To ensure the depositary has an overview of all the assets of the UCITS fund and both fund managers and investors have a single point of reference in the event that problems occur, the Directive also requires the appointment of a single depositary, in order to have full oversight over the assets of the UCITS fund. This is already standard practice in the UK so will not impact on existing business models.

It is worth stressing that all depositaries currently authorised by the FCA and the PRA will retain their permissions. The FCA are responsible for implementing this aspect of the Directive and do not intend to restrict the existing population of firms who can act as depositaries and implementing UCITS V will allow non-bank depositaries (i.e. firms authorised as depositaries which are not credit institutions) to continue providing their services.

2. Delegation of custody. UCITS V lays out specific conditions in which the depositary's safekeeping duties may be delegated to a sub-custodian. These are aligned with those conditions that are applicable under the AIFMD (2011/61/EU). The aim of these measures is to align conditions of duties delegated to a sub-custodian across UCITS and AIFMD because this ensures a consistent approach across fund types and ensures clarity for investors surrounding delegation rules no matter the activities of the fund. The aim of these measures is to safeguard against improper use of the fund's assets, strengthening investor protection. The European Commission's UCITS V impact assessment concludes that the delegation of custody should be governed by rules on diligence in selecting and appointing a sub-custodian, and on the ongoing monitoring of the sub-custodian. The intended effect of this is to ensure good practice oversight and therefore strengthen investor protection.

3. Liability. Under UCITS V, the depositary is liable to the UCITS fund and to investors for losses by the depositary or third party to whom custody was delegated. This liability measure ensures a greater level of protection to UCITS funds and investors. UCITS V seeks to introduce a harmonised liability standard that obligates depositaries to return instruments lost in custody irrespective of fault or negligence. This will ensure a high level of investor protection and help achieve a uniform standard across the EU. Again, achieving a uniform standard across the EU will help to further enhance UCITS funds reputation globally. Unlike the AIFMD, UCITS V does not allow depositaries to transfer liability for losses to a delegate in any circumstances.

The majority of implementation duties for the Depositary provisions will fall to the FCA, as outlined above. HMT will be transposing the remainder of the provisions in its statutory instrument, including relevant updates to FSMA and secondary legislation where necessary.

Remuneration.

UCITS V introduces a requirement for the UCITS management company to implement a remuneration policy that is consistent with sound risk management of the UCITS fund. The proposed requirements in the UCITS Remuneration Code are broadly similar to those in the AIFMD Remuneration Code because of the similarities of the risks and the incentives in the two sectors. In general, implementing the remuneration principles under UCITS V will therefore standardise the approach to remuneration across industry.

The remuneration principles will seek to:

- Promote sound and effective risk management and will not encourage risk taking that is inconsistent with the risk profile of the UCITS instruments under management, and will not conflict with the management company's duty to act in the best interest of the fund. The aim is to minimise incentives for fund managers to take excessive levels of risk as this can have a negative impact on investors (i.e financial losses) and cause wider concerns such as financial destabilisation. It could also negatively impact the reputation of the UCITS brand, and therefore have the wider effect of restricting industry growth.

- Include the fixed and variable components of salaries and discretionary pension benefits. The intended effect of this is to ensure complete transparency surrounding remuneration policies, which is important because investors should understand their investment manager's performance incentives.
- Align with the business strategy, objectives and values of the management company, the UCITS under management and the investors in such UCITS, and will seek to avoid conflicts of interest.
- Increase transparency of remuneration by requiring details of the up-to-date remuneration policy in the investor prospectus, and include a total and full breakdown of remuneration for the financial year to be included in the annual report. Again, this aims to ensure full transparency of the companies' practices to investors.

The remuneration provisions in UCITS V apply to:

- Senior management;
- Risk taking roles;
- 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 profile of the management company or the UCITS that they manage.

UCITS V requires UCITS management companies to comply with a detailed list of Principles when establishing and maintaining their remuneration policies and practices. In particular, UCITS management companies must:

- Balance fixed and variable remuneration components appropriately and ensure that they have the option of paying no variable remuneration;
- Only pay guaranteed variable remuneration in the first year following a new hire and even then only in exceptional circumstances;
- Use both non-financial and financial criteria to assess performance in the context of a multiyear framework with an adjustment mechanism capable of integrating all types of current and future risks;
- Only pay variable remuneration if it is sustainable according to the UCITS Manager's financial situation as a whole. It must be considerably contracted where either the UCITS Manager or the UCITS concerned performs badly;
- Defer between 40 – 60% of variable remuneration over a three to five year period, subject to the over-riding requirements that the deferral period is (1) appropriate in view of the holding period recommended to the UCITS' investors, and (2) correctly aligned with the nature of the risk of the UCITS in question;
- Pay a substantial portion (of at least 50%) of the variable remuneration component in non-cash instruments such as units of the UCITS concerned, equivalent ownership instruments or other instruments with equally effective incentives. Where the management of UCITS accounts for less than 50% of the total portfolio managed by the UCITS Manager the 50% minimum does not apply, but the obligation to pay a substantial portion of variable remuneration in non-cash instruments remains. However, this is subject to the UCITS legal structure, its fund rules or instruments of incorporation;
- Link early termination payments to performance; and
- Hold discretionary pension benefits in non-cash instruments for five years if a staff member leaves before retirement. Following retirement, UCITS Managers must also pay discretionary benefits in the form of non-cash instruments which must be subject to a five year retention period.

The above provisions are to be implemented by the FCA through amendments to their rules.

Similarly to other EU legislation, the UCITS Directive allows a proportionate approach in the application of the remuneration principles. The Directive states that management companies shall comply with the remuneration principles *'in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities'*. (Please see Article 14b(1) of the UCITS Directive).

The FCA believes that the principle of proportionality is a cornerstone of the UCITS Directive. Proportionality ensures a consistent application of the underlying principles that govern remuneration, allowing for the alignment between long-term risk and individual reward. This ensures a close correlation of a firm's remuneration policies and practices with its prudential and conduct risk profile. Pursuant to the proportionality principle, UCITS Managers need only comply with the principles in a way and to an extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities.

Given the similar wording on proportionality in the UCITS Directive, the AIFMD and other EU legislation, the FCA consider it appropriate to take the same approach for management companies of UCITS. The FCA are proposing specific guidance allowing the disapplication of certain remuneration principles when the remuneration paid to a member of the UCITS Remuneration Code staff falls below certain minimum thresholds. This proposal will reduce any unnecessary burden on smaller-size firms across industry.

National Sanction Regimes.

The policy aim is to achieve minimum harmonisation of sanction regimes by requiring:

- A minimum catalogue of administrative sanctions and measures (including harmonisation of the lower bound of the maximum amounts of administrative fines);
- A minimum list of sanctioning criteria; and
- Competent authorities and management companies to establish whistle-blowing mechanisms.

This sanction regime applies to a catalogue of breaches of the main investor protection safeguards in the UCITS Directive. Key incidents that lead to penalties being incurred will arise when:

- The activities of UCITS are pursued without authorisation;
- The business of a management or investment company is carried out without authorisation, or where authorisation has been obtained through false statements;
- A qualifying holding in a management company exceeds or falls below certain thresholds without notifying the competent authority;
- Failing to notify the competent authority at least annually of the names of shareholders and members possessing qualifying holdings and the size of these holdings;
- Failing to comply with structural, organisational and procedural arrangements imposed by UCITS V;
- Failing to comply with requirements related to delegation of a management or investment company's functions to third parties;
- Failing to employ a risk management process; or
- Failing to disclose relevant information to investors as required by UCITS V.

For those individuals who breach the rules, the administrative sanctions will include:

- A permanent or temporary ban from fund management;
- Suspension of authorisation;
- A fine of up to EUR 5 million;
- Additionally, companies could be fined 10% of their annual turnover or alternatively at least twice the amount of the benefit gained from the infringement, where this is determinable.

All UCITS firms and depositaries authorised in the UK will already be subject to the minimum sanctions imposed by UCITS V, because the sanctions listed above replicate sanctions that are already available to the FCA domestically, as provided for by existing UK legislation under FSMA, and enforced by way of FCA rules. Indeed the domestic sanctions presently available to the FCA for breaches of the UCITS directive go beyond the minimum sanctions set out in UCITS V, so HMT does not need to specifically implement the UCITS V sanctions in its regulations. It is therefore expected that sanctions under UCITS V will have minimal impact on industry. Any effects of imposing these sanctions are unlikely to be felt by UK firms unless they are breaking the law, in which case it is right to be held accountable for improper

conduct and/or practices. However, it is still important at an EU level to bring the UCITS Directive sanctions into line with other existing legislative sanctions, as it promotes the strength of the UCITS brand, ensures investor protection is uniform across industry, and will bring into line any Member States who do not currently have strict sanction regimes.

Benefits.

The most significant benefit of UCITS V is to investors. UCITS V is expected to deliver major improvements to safeguarding stability and enhancing consumer protection. Both investors and industry have generally welcomed these reforms and the new protections they offer. The benefits of the Directive are difficult to quantify because the scale of the benefits depends on the extent to which risks to proper conduct with regard to investments and, potentially, financial stability risks, are adequately reduced.

In addition, as the Directive introduces important improvements to investor protection and measures to decrease risk associated with fund operations, it is foreseen that UCITS V will enhance the reputation of the UCITS framework, which could in turn increase investment in UCITS. Again, this is difficult to quantify.

Costs.

UCITS V will apply to a well-defined group of fund management firms, depositaries, and UCITS funds, operating under the existing UCITS regime, including:

- Approximately 150 firms with a Part 4A permission under FSMA for 'managing a UCITS';
- 11 firms with a Part 4A permission under FSMA for 'acting as a depositary of a UCITS';
- Approx. 1300 UCITS schemes authorised in the UK (this number includes both umbrella and sub-funds).

UCITS funds and depositaries will inevitably incur some costs during the implementation of the UCITS V Directive. As part of the consultation process, HMT is consulting on the potential costs to industry. A number of these may be one-off administrative costs borne by UCITS funds or depositaries when implementing the changes to UCITS regulations. We will be seeking information on the familiarisation costs to industry during the consultation period. Some structural changes to fund operations and governance may require additional ongoing costs to UCITS funds and/or fund depositaries.

To gain evidence of the costs to industry, HMT will be requesting information from depositaries and UCITS management companies on the changes firms will need to make in order to fully comply with depositary provisions laid out under UCITS V, and how much these changes will cost (including familiarisation costs).

While HMT will be gathering evidence of the costs during the consultation, a consideration of the costs and benefits to industry, along with some initial cost forecasts, are considered in the cost/benefit analysis below.

Cost/Benefit analysis

Depositaries

Costs

As set out above, firms in the UK already appoint a single depositary and rules on eligibility are already enforced by the FCA.

Practical implications of UCITS V provisions for depositaries are expected to be as follows:

- Depositary agreements which are currently in place in respect of UCITS Open-Ended Investment Companies (OEICs) are likely to need to be re-papered. As with AIFMD, the depositary community will prepare new template agreements for negotiation.
- UCITS unit trusts may need a depositary agreement for the first time and the existing trust deed is likely to require amendment to give the power for such an agreement to be entered into.
- The disclosure requirements to investors in the fund prospectus will also need to be updated to reflect the new depositary regime.

In consideration of the above implications, costs to UK depositaries may be incurred where they are required to change their operational or administrative practices in order to comply with the UCITS V Directive. This may include:

- Changes to ensure harmonisation of the depositaries' duties. This includes keeping the assets of the UCITS safe, monitoring cash movements to and from the fund, and segregation requirements for assets that are held in custody. This may incur legal and compliance costs;
- Depositary contract agreements which are currently in place in respect of UCITS OEICs are likely to need to be refreshed. While it is common to have contracts in place, it is not currently an absolute requirement in the UK and so setting up contractual agreements will incur costs. However, even where there are contracts in place, these will have to be reviewed and updated to meet all the detailed requirements in the UCITS V Regulation. While depositaries should be able to leverage off work carried out for AIFMD, it will still incur costs. The depositary community will prepare new template agreements for negotiation, resulting in administrative costs to depositaries;
- UCITS unit trusts will need a depositary agreement and the existing trust deed may require amendment to give the power for such an agreement to be entered into. This may result in legal and compliance costs;
- When delegating to a sub-custodian, the depositary must continually monitor the actions of the sub-custodian. This may incur ongoing administrative costs;
- The disclosure in the prospectus will also need to be updated to reflect the new depositary regime. This is likely to incur a one-off administrative cost;
- Any familiarisation costs incurred by complying with the UCITS V Directive.

HMT will be consulting on the costs to industry incurred by implementing the depositaries provisions laid out under UCITS V. However, it is currently difficult to estimate the monetised costs to industry, particularly because the Level 2 delegated legislation in the UCITS V Directive concerning the depositary requirements has not yet been produced at the European level.

It is worth noting that 10 of the 11 registered depositaries in the UK also operate as depositaries for AIFs. By complying with rules for depositaries under AIFMD, these depositaries are already complying with requirements which are broadly comparable with the rules laid out in UCITS V (or they are at least familiar with the requirements), which should ease implementation.

Where provisions laid out under UCITS V diverge from AIFMD, there may be additional costs for depositaries which are derived from:

- The new limitations on the reuse of assets of the UCITS;
- The ban on the depositary from transferring the liability for losses of financial instruments held in custody (which is allowed in limited circumstances under the AIFMD); and
- The independence and delegation requirements which will be set out in the UCITS V Level 2 measures.

These are costs which the depositary may be able to recoup from higher fee charges to the UCITS fund or the management company.

As a pre-consultation stage estimate, HMT has been informed that based on initial and broad estimates for one UK depositary, the costs could be positioned as £3.55 - £3.87 million total cost for that depositary. However this cost estimate is only a one-off implementation total for one depositary and so is not applicable across all UK depositaries. This estimate is based on the depositary's response to the UCITS V requirements (including legal costs), most notably asset segregation and chain of custody

obligations. While this cost is not indicative of costs to all 11 UK Depositaries, it may give a sense of the scale of costs. The estimates for total costs to industry given on the summary pages are calculated from the above estimate of £3.71 million (the midpoint of the range £3.55-£3.87 million), multiplied by 11 (the total number of UK depositaries). This totals £40.81 million. It should be noted that we do not expect all 11 depositaries to incur costs as high as £3.71 million, and so this total cost forecast may be at the higher end of estimated costs to industry. As such this figure has been listed as a 'high estimate' on the summary page of this impact assessment. We have not yet received sufficient information from industry to estimate a low end estimated figure. HMT will be seeking further evidence on the costs across industry during the consultation stage, as highlighted by the specific consultation questions flagged above.

Benefits

The amendments proposed under UCITS V are intended to enhance those safeguards that are already embedded in the UCITS framework. Uniform rules on the current tasks of the depositary, on the conditions and diligence to be applied when delegating these tasks to third parties, and on the liability of depositaries, have the potential to boost investment and increase confidence in the UCITS brand, especially where UCITS are sold across borders. Currently, Member States apply different standards on depositaries, which means that consumers benefit from different levels of protection depending on in which country they have invested.

Harmonising these rules will benefit retail investors by reducing uncertainty and ensuring they can continue to trust UCITS, whether marketed across borders or not. The same holds for rules on remuneration and sanctions. Moreover, enhanced provisions on the delegation of tasks by depositaries, their due diligence, and their liability will provide for greater confidence in UCITS that invest in emerging markets in particular. This could ultimately widen the breadth of investment opportunities for retail investors.

The new rules on depositaries' duties will achieve safeguards against fraud and improper conduct, and are introduced through a series of measures, including:

- Specifying that a single depositary should be used for each UCITS fund. This is already standard practice in the UK, but the requirements under UCITS V will improve standardisation across the EU. Appointing a single depositary will ensure that the depositary has an overview of all of the UCITS fund assets and both fund managers and investors will have a single point of reference in the event that problems occur in relation to the safekeeping of assets or the performance of oversight functions. Although already a requirement for UK depositaries, this measure will enhance investor protection and transparency for investors across the EU. The requirement to appoint a single depositary is also already required by AIFMD, and so this further brings into line requirements for depositaries across the industry;
- Specifying that the appointment of a depositary shall be evidenced by a written contract, including a uniform list of oversight duties established in contractual form. The benefit of this standardisation will be to ensure a harmonised approach to the depositaries' duties in all Member States irrespective of the legal form of the UCITS. This will guarantee an appropriate level of regulation and ongoing control over depositary practices and conduct, therefore improving investor protection;
- Specifying that depositaries should have oversight of and ability to monitor all assets, cash included. This is to prevent against fraudulent cash transfers;
- Segregation requirements will also require any financial instruments of a UCITS fund held on the depositary's book to be at all times distinguishable from the depositary's own assets. Separating the depositaries own assets from the UCITS fund assets, and requiring Member States to ensure that assets of the UCITS are not available to a depositary's creditors upon insolvency, will provide an additional layer of protection for investors should the depositary default.

As already discussed, at present there are 11 depositaries in the UK, and due to the similarities in the depositary requirements laid out under AIFMD, many of these depositaries will be familiar with the provisions proposed and may already have procedures and operational arrangements in place that will make it easier to comply with the above UCITS V depositary provisions.

Laying these rules under UCITS V will have the wider benefit of bringing into line the UCITS Directive with other legislation such as AIFMD, and will improve investor protection in those Member States who do not currently have strict rules for depositaries. Laying out these rules under UCITS V will also have the benefit of ensuring that fringe companies cannot act questionably or engage in improper practice or conduct.

Remuneration.

Costs

Practical implications of implementing the remuneration provisions under UCITS V Directive include the following:

- Firms will need to carry out a gap analysis against the remuneration policies they have in place currently under existing regulatory requirements (AIFMD for example) to see what changes need to be made. In many cases management companies do not actually have any direct employees so it is potentially unclear how these rules will apply.
- To the extent that any staff member is to receive remuneration by way of units in the UCITS, firms will need to consider if a new share class will need to be issued and what the terms of that share class should be. It is clear that staff will not be able to vote on any shareholder resolutions, however, as they will be associated with the manager.
- Prospectuses, KIIDs and annual reports will need to be amended to include details of the approach to remuneration.

Responsibility for implementing the remuneration provisions under UCITS V falls to the FCA, who will be taking an 'intelligent copy-out' approach, whereby they will seek to not go further than the minimum requirements laid out in the Directive, where possible.

In consideration of the above implications, costs to UK firms may be incurred through the obligation to assess existing remuneration policies and structures against the requirements of UCITS V. Firms will need to establish changes needed to remuneration structures to ensure they are in line with the principles outlined in UCITS V. This may incur some operational costs. For example, to the extent that any staff member is to receive remuneration by way of units in the UCITS, firms will need to consider if a new share class will need to be issued and what the terms of that share class should be.

Prospectuses, KIIDs and annual reports may need to be amended to include details of the approach to remuneration. The alteration of disclosure documents will likely incur an administrative cost to industry, on which HMT will consult further, as highlighted in the specific consultation questions set out above.

HMT will be consulting on the monetised administrative and operational costs, including familiarisation costs, which may be incurred by the implementation of remuneration provisions under UCITS V. Many investment management companies will already have in place structures that comply with the UCITS V provisions, however, for those who do not comply, the FCA forecast that costs incurred will be comparable to remuneration costs incurred under AIFMD. Therefore to estimate the costs incurred by implementing the remuneration rules at the pre-consultation stage, we believe we can broadly read across costs stated by the Financial Services Authority for the implementation of remuneration provisions under AIFMD (see table 1). The range of figures quoted for the remuneration provisions under AIFMD in table 1 represent the highest and lowest costs cited by investment management companies during the consultation process.

Table 1. UCITS V estimated costs for investment managers based on the application of remuneration rules under AIFMD (source: http://www.fsa.gov.uk/static/pubs/cp/cp12-32.pdf).

Costs	**Incremental Costs**	
	One-Off	**Ongoing (annual)**
For changing: • The way remuneration policies are set;	£0-£300,000	£0-£50,000

• Systems and controls; • Additional data collection; • Reporting; and • Record keeping requirements.		
Issuing an annual remuneration statement	£0-£100,000	£0-£30,000
Senior Management Board or committee time	NA	£0-£24,000
Enhanced risk management function	NA	£0-£31,000
Adjusting remuneration structures	£0-£47,000	£0-£50,000
Average of total costs	£7,000	£4,000

For pre-consultation estimation purposes, using the above costs incurred under AIFMD, we predict the costs for implementing the remuneration provisions laid out under UCITS V will be approximately:

Costs	One-Off	Ongoing (annual)
Total cost to industry (no. of investment management companies [c.150] x averages of remuneration costs under AIFMD)	£1,050,000	£600,000

It should be noted that the total cost estimates above are only indicative of overall costs to industry if **all** UK firms (c.150) have insufficient or no remuneration principles in place. However, many firms will already comply with remuneration principles laid out in the FCA handbook or those provided by the Capital Requirements Directive, and so they may be broadly familiar with the remuneration requirements laid out under UCITS V. Therefore, the total cost estimate stated above may be more than the costs actually incurred by industry. More detailed information on remuneration provisions will be gathered at consultation.

Benefits

The requirement for UCITS management companies to have remuneration policies that comply with certain remuneration principles and cover their key staff (those whose professional activities have a material impact on the risk profile of the UCITS), will both promote effective risk management, and will have the benefit of increasing transparency for investors.

As the Directive will promote alignment between pay and performance, companies may benefit by recouping unwarranted high payment for under performance through various mechanisms including malus or clawback arrangements.

National Sanction Regimes.

Costs

Under the FSMA, the FCA already has the power to impose an unlimited fine on any authorised person that they consider has contravened a relevant requirement imposed on them (including a requirement under FSMA, FCA rules or any directly applicable EU provision – this will include contraventions of UCITS directive provisions as transposed by HMT or FCA in legislation or rules). The ability to impose an unlimited fine will remain applicable to those managing a UCITS or acting as a depositary of a UCITS who contravene relevant requirements, including those who undertake controlled (key) functions for those entities. Equally the other administrative sanctions imposed by the regulation, namely public statements, orders requiring the person responsible to cease particular conduct, suspension or withdrawal of authorisation, and temporary or permanent bans, are already available to the FCA under existing domestic powers in FSMA and are enforced through FCA rules. The minimum sanctions measures under UCITS V will not therefore impact firms and depositaries in the UK beyond existing UK requirements.

Benefits

UCITS V defines a common approach to, and a clear list of, the main breaches of the UCITS Directive. It also lays out the administrative sanctions and measures that Member State competent authorities should

be empowered to apply in respect of the main breaches. So, although we do not expect changes to impact UK firms, this common approach towards breaches of the UCITS Directive will ensure consistency across EU UCITS funds and will overall be beneficial to the reputation of UCITS. It will have the benefit of bringing into line those Member States who do not currently have strict sanction regimes enforced in their own legislation. This will ensure standardisation across the EU. It is important to ensure the standardisation of sanction regimes so that no Member State can be unduly lenient towards companies that act with improper conduct or practice, as this would negatively impact investor protection and in turn the overall reputation of the UCITS brand.

Further work

HMT will conduct a more detailed cost/benefit analysis once the consultation on costs to industry has been completed. However, offsetting the cost of implementing the UCITS V Directive against the overall benefits of securing a more stable UCITS fund market, and therefore overall improvement of UCITS funds' reputation as a highly attractive global brand, is difficult to quantify.

Risks and Assumptions.

HMT will be consulting on the main risks and assumptions associated with implementing the UCITS V Directive. However, the major foreseen risks and assumptions are as follows:

- **Depositaries.** The main assumptions are based on the ability to decrease risk by implementing the rules for depositaries as laid out by the UCITS V Directive.
- **Remuneration.** The main assumption related to remuneration is that implementation of the UCITS V Directive will successfully ensure that a fund manager's remuneration (and the remuneration of those staff whose professional activities have a material impact on the risk profile of the UCITS) is proportional to performance. Competition for staff in the UCITS fund management market may prevent the application of meritocratic remuneration policies. Additionally, some management companies do not actually have any direct employees, so it is potentially unclear how the rules surrounding remuneration will apply.
- **National Sanction Regimes.** HMT does not anticipate any major risks and assumptions associated with the harmonisation of national sanction regimes.

Wider Impacts.

The Directive will affect present and potential UCITS funds, present and potential depositaries of those funds and present and potential investors of UCITS funds. HMT does not anticipate any wider impacts of the UCITS V Directive.