



HM Treasury

Undertakings for Collective Investments in Transferable Securities (UCITS) V Directive:

consultation response

October 2016



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1 Executive Summary

1.1 UCITS stands for Undertakings for Collective Investments in Transferable Securities. UCITS are a type of regulated investment fund.

1.2 The first UCITS Directive was adopted in 1985. It created greater business and investment opportunities for both industry and investors by integrating the EU market for retail investment funds. The Directive, and its subsequent revisions, 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. These common rules for this type of investment fund relate to, amongst other things, investment policy, risk management and investor disclosure. Funds that meet these rules may be marketed across the EU based on home state authorisation. This regulatory framework has been periodically updated to ensure it remains up to date.

1.3 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 the risk surrounding the management of UCITS funds, and to build consumer protection and trust in the market. Overall, the aim is to further improve the reputation of UCITS funds as a global brand that is highly attractive to investors.

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

1.5 UCITS V addresses three main areas of UCITS fund legislation: depositaries, remuneration and national sanction regimes.

Depositaries

1.6 UCITS V seeks to address three key aspects of depositary governance and practices, in line with the principles of ensuring good practice oversight, strengthening investor protection and creating a uniform standard across the EU. The provisions on depositaries can be broadly be categorised as:

- **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
- **delegation of custody of a UCITS fund's assets** - 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 Alternative Investment Fund Managers Directive (2011/61/EU)
- **liability of a UCITS fund's assets** - 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

1.7 10 of the 11 registered depositaries in the UK also operate as depositaries for Alternative Investment Funds (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). This should ease implementation.

1.8 All depositaries currently authorised by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority will retain their permissions.

Remuneration principles

1.9 UCITS V introduces a number of remuneration provisions with the aim of promoting the principles of sound and effective risk management, and discouraging risk taking that is inconsistent with the risk profile of the UCITS instruments under management. The provisions should also increase transparency of firms' practices to investors and create a uniform standard across the EU.

1.10 The remuneration provisions:

- include the fixed and variable components of salaries and discretionary pension benefits
- align incentives with the business strategy, objectives and values of the management company, the UCITS under management and the investors in such UCITS funds, and 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 to include a total and full breakdown of remuneration for the financial year to be included in the annual report

National sanction regimes

1.11 The policy aim of the sanctions provisions is to achieve minimum harmonisation of sanction regimes across Member States 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
- Competent Authorities and management companies to establish whistle-blowing mechanisms

The UCITS V Directive consultation

1.12 HM Treasury ran a consultation on the implementation of the UCITS V Directive from 23 October to 17 December 2015. There were 4 responses to the consultation from individual firms and trade bodies, which represent a wide range of investment managers, alternative investment managers, and depositaries. (See list of consultation respondents in chapter 5).

1.13 This summary of consultation responses should be read in conjunction with the Final Stage Impact Assessment published alongside this document.

1.14 On 23 June 2016, the EU referendum took place and the people of the United Kingdom voted to leave the European Union. Until exit negotiations are concluded, the UK remains a full member of the European Union and all the rights and obligations of EU membership remain in

force. During this period the government will continue to negotiate, implement and apply EU legislation. The outcome of these negotiations will determine what arrangements apply in relations to EU legislation in future once the UK has left the EU. The assumptions used in this consultation have been chosen accordingly.

2 Implementation of the UCITS V Directive

Introduction to the Directive

2.1 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. At the end of March 2015, the assets under management of UCITS funds globally were over EUR 8.28 trillion, representing 65% of all investment fund assets in Europe¹. In the UK, there are currently c.150 authorised management companies 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.

2.2 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 to clarify and strengthen the regulation and supervision of UCITS depositaries (among other operational aspects of UCITS funds)
- consolidate the level of protection of UCITS investors
- further strengthen the UCITS brand and attract investment

Submissions to that consultation suggested reforms in the areas of fund depositaries, remuneration and national sanction regimes.

2.3 In July 2012, the European Commission formally proposed a reform of the UCITS Directive, commonly referred to as 'UCITS V'. UCITS V was politically agreed in 2014 and came into force in the UK in March 2016. UCITS V amends the previous versions of the UCITS Directive.

2.4 UCITS V is an EU Directive. The UK, like other Member States, is obligated under the Treaty on the Functioning of the European Union to transpose the Directive into national law. The transposition deadline was 18 March 2016. As UCITS V is a minimum harmonising Directive, the UK has discretion to impose stricter standards. In the case of administrative sanctions, for example, the UK's 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, HM Treasury has decided (wherever possible) not to go beyond the minimum requirements imposed by the Directive.

Implementation Duties

2.5 In terms of division of implementation duties, HM Treasury has been responsible for the parts of the UCITS V Directive that are more structural in nature, and the FCA has been responsible for implementing the majority of the rules that directly impact consumers and industry.

2.6 HM Treasury's statutory instrument contains provisions to transpose the Directive requirements as to depositary liability for loss of financial instruments, obligations on the

¹ EFAMA Quarterly Statistical Release, No. 61.

competent authority, the FCA, as regards sharing of information and reporting of infringements, publication of penalties for contravention of the Directive and certain miscellaneous provisions. Where applicable, the statutory instrument updates the Financial Services and Markets Act 2000 (FSMA) and relevant secondary legislation to put into effect the Directive requirements alongside the existing domestic framework. Where possible HM Treasury has sought to minimise the impact on industry, while implementing the Directive in full.

2.7 The FCA has been responsible for implementing 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))
- whistleblowing requirements applicable to the depositary and the management company

2.8 The FCA consulted separately on the changes to their rules.²

² <https://fca.org.uk/your-fca/documents/consultation-papers/cp15-27>

Responses to the UCITS V Directive Consultation

3

Responses to the Consultation

3.1 HM Treasury ran its consultation on the implementation of the UCITS V Directive from 23 October to 17 December 2015. The consultation included the draft Statutory Instrument and a consultation-stage Impact Assessment.

3.2 Stakeholders were asked to provide responses to questions on the approach to HM Treasury's implementation of the Directive in the draft Statutory Instrument, as well as the overall costs to industry that are likely to be incurred by complying with the Directive as a whole. As stated above, HM Treasury received 4 responses to the consultation, including from an individual firm and trade bodies, which represent a wide range of investment managers, alternative investment managers and depositaries/trustees.

3.3 Three of the 4 respondents directly responded to the consultation document published by HM Treasury, however only two of those directly answered HM Treasury's questions as laid out in the consultation. The fourth respondent provided HM Treasury with a copy of the issues raised to the FCA in a response to their consultation on UCITS V implementation. This respondent dealt only with remuneration policy, which did not fall to be implemented by HM Treasury.

3.4 Responses to the list of questions put to the UCITS industry as part of the consultation process, were as follows:

Question 1. Do you agree that a copy-out approach is the correct way to implement the provisions for depositary liability (see regulation 3 of the Statutory Instrument, which inserts regulations 15B-D into the Undertakings for Collective Investment in Transferable Securities Regulations 2011)?

3.5 All respondents agreed that a copy-out approach as outlined in the consultation was the correct implementation method. One response noted that this approach is in keeping with the government's commitment, as stated in its UK Investment Management Strategy paper (paragraph 4.6) – "a 'copy out' approach will be adopted wherever possible to implementing European legislation in order to simplify the regulatory approach for firms, with any gold plating supported by strong justification."¹

Question 2. Do you agree with HM Treasury's approach to implementing the provisions for distribution of assets upon insolvency?

3.6 In relation to the provision in the Directive for distribution of assets upon the insolvency of a depositary, HM Treasury had taken the position that:

- 1 Article 22.8 captures only those financial instruments that are actually held in custody at the point of insolvency. Those assets that a depositary (or delegate) does not hold in custody (whether or not as a result of a compliance failure) would not be caught by the Article

¹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/258952/uk_investment_management_strategy_amended.pdf

- 2 no specific implementation measure was required to transpose Article 22.8 of the Directive, as existing UK domestic legislation, FCA rules and insolvency law operate in conjunction to ensure that custody assets are protected from creditor distribution upon the insolvency of a UK depository

3.7 Only one stakeholder specifically responded to this question. In relation to point (a) the stakeholder agreed that Article 22.8 relates to those assets which are *de facto* (in fact) held in custody, as opposed to those which *de jure* (by right of law) ought to be held in custody, and that there is consequently no requirement in implementing Article 22.8 to put in place provisions relating to restitution or imposing trusts on assets which wrongfully have not been placed in custody.

3.8 In relation to point (2), the stakeholder responded that absent some statutory trust being created (which is likely to help, but recognised that there will be requirements of separation, marking and evidence), they agreed that in combination the registration requirements and general law ought to meet the demands of Article 22.8.

3.9 HM Treasury therefore decided to maintain its position that no specific implementation measure was required to transpose Article 22.8 of the Directive.

Question 3. If you do not agree with HM Treasury's position that the provisions for the distribution of assets upon insolvency do not require substantial changes to the law, what are your suggestions for practical implementation of these measures?

3.10 No stakeholders responded with further information to this question.

Question 4. What are your cost forecasts to ensure initial and ongoing compliance with all of the depository provisions laid out under UCITS V, to be implemented by both HM Treasury and the FCA?

3.11 Only one stakeholder responded to this question, noting that they anticipated the initial and ongoing costs of complying with the depository provisions to be significant and not of "limited impact" as described in the consultation paper. The stakeholder noted the difficulty in quantifying these costs, because (at the time of writing) the UCITS V Level 2 Delegated Acts of the European Commission were yet to be published. The stakeholder noted that costs were likely to vary significantly between depositories depending on their operating models, but that all of the potential costs identified in the consultation would be relevant and may require significant operational changes.

3.12 HM Treasury took on board this response, and revised the Final Stage Impact Assessment cost forecast to reflect the potential variation in costs, noting that costs may range from limited to significant.

Question 5. Do you foresee any other type of cost not listed above that depositories may incur when ensuring they comply with the depository provisions laid out under UCITS V?

3.13 One stakeholder noted that in addition to the costs listed in the consultation paper, significant costs may be incurred relating to keeping abreast of changes to insolvency law in the various jurisdictions in which they hold investments in custody on behalf of their funds.

3.14 Another stakeholder did not foresee any other type of cost than those listed in the consultation.

3.15 HM Treasury took on board this response, noting these additional costs in the Final Stage Impact Assessment, and adapting the scale of the costs to account for this.

Question 6. Do you agree with HM Treasury's view of the practical implications that fund management firms will face in order to ensure they comply with the UCITS V remuneration provisions?

3.16 Only one stakeholder responded to this question, noting that depending on the final changes to FCA rules, firms may additionally have to assess the implications the new provisions might have on delegation arrangements. For example firms may have to assess if their global remuneration policy is compatible with the new UCITS rules.

Question 7. Do you believe there are any additional implications that fund management firms will face in order to ensure they comply with the UCITS V remuneration provisions?

3.17 Only one stakeholder responded to this question, noting that firms may have to undertake a new proportionality assessment for their UCITS business.

Question 8. What are your immediate familiarisation and ongoing cost forecasts to ensure compliance with the remuneration provisions laid out under UCITS V?

3.18 No stakeholder responded to this question.

Question 9. Do you agree with HM Treasury's approach to implementing the national sanctions provisions under UCITS V (set out in regulation 2 of the statutory instrument)?

3.19 Two stakeholders who responded to this question agreed with HM Treasury's approach and one stakeholder noted that Regulation 2 of HM Treasury's draft Statutory Instrument seemed to make all the necessary changes.

Question 10. Do you agree that the approved persons and accountability regime in Part V of FSMA covers all members of management bodies of UCITS management companies, investment companies and depositaries? If not, which members of management bodies would not be covered by those regimes?

3.20 Both stakeholders who responded to this question agreed.

Question 11. What level of impact and cost do you forecast the National Sanction Regime provisions laid out under UCITS V to have on industry?

3.21 No stakeholder responded to this question.

Question 12. Do you foresee any other impact that the provisions for National Sanction Regimes will have on fund management companies, fund managers, depositaries or trustees?

3.22 No stakeholder responded to this question.

Question 13. What are your estimated cost forecasts for ensuring immediate and ongoing compliance with the National Sanction Regime provisions laid out under UCITS V?

3.23 No stakeholder responded to this question.

Question 14. Do you agree that the draft Statutory Instrument correctly implements all of the Directive requirements not described in other parts of this paper?

3.24 Both stakeholders who responded to this question agreed that the draft Statutory Instrument correctly implements the Directive requirements.

Question 15. Are there any other matters that should be addressed?

3.25 Only one stakeholder responded to this question, noting potential prospectus changes as raised in the FCA consultation. This relates to FCA rules whereby there may be a need to obtain prior FCA approval for prospectus changes, which would result in little time for firms to meet or undertake the necessary requirements. The stakeholder proposed that amendments to the OEIC (open-ended investment company) regulations could be made as a solution to this issue.

3.26 HM Treasury noted this concern and after consulting with the FCA, took the decision that amendments to OEIC regulations were not required for UCITS V implementation. No amendments were therefore made to the implementing Statutory Instrument.

Question 16. Overall, do you agree with HM Treasury's proposed approach to the transposition of requirements affecting UCITS funds?

3.27 Of the two stakeholders who responded to this question, one noted that overall they agreed with HM Treasury's proposed approach to transposition.

3.28 The other stakeholder noted that they largely agree with HM Treasury's proposed approach to the transition requirements affecting UCITS funds, but highlighted that at the time of writing the UCITS V Level 2 delegated act had not been published and so they could not fully comment. Timing concerns were raised regarding this issue.

3.29 HM Treasury noted these responses and the timing concerns regarding the EU implementation deadline of 18 March 2016.

Question 17. Do you have any other information that does not relate to any of the consultation questions above that you feel would be beneficial to HM Treasury during the implementation of the UCITS V Directive?

3.30 One stakeholder raised the issue that the way in which certain European Directives and Regulation have been implemented into UK legislation has resulted in confusion around apparently conflicting definitions.

3.31 HM Treasury has noted this point, but as it is a broader issue, it will be fully considered once the current EU legislative programme (including the MiFID II Directive) has been implemented.

Outcome of the Consultation

3.32 HM Treasury took into account the views of those stakeholders who submitted responses to the consultation, as detailed above.

3.33 However, no significant changes to the implementing Statutory Instrument were made before it was laid in draft under the negative procedure on 25 February 2016.

3.34 UCITS V came into force in the UK on 18 March 2016.

4 UCITS V Delegated Act

4.1 The UCITS V delegated regulations, commonly referred to as the 'level 2' measures (Commission Delegated Regulation (EU) 2016/438 of 17 December 2015 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries) were adopted on 17 December 2015 and published in the Official Journal of the European Union on 24 March 2016. The level 2 entered into force on 13 April 2016 and will apply from 13 October 2016.

4.2 The FCA has lead on the implementation of the Level 2 delegated regulations, and have separately consulted on these provisions. The FCA consultation on the Level 2 delegated regulation (CP16/14) ran from 19 May 2016 to 19 July 2016. It is available at: <https://www.fca.org.uk/static/documents/consultation-papers/cp16-14.pdf>

A Respondents to the Consultation

A.1 HM Treasury would like to thank the respondents to the UCITS V consultation:

- The Investment Association
- The Depositary and Trustee Association (DATA)
- Alternative Investment Management Association Limited (AIMA)
- ETF Securities (UK) Limited

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