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Investment Management Alert

Fortress Europe? UCITS V and the US Fund Manager

The European Parliament and Council recently agreed on the substance of the new UCITS V Directive, which will include safeguards to protect client assets in the event of a depositary's insolvency and also address remuneration practices that are thought to encourage excessive risk-taking. These new rules may make it more cumbersome for UCITS that are either managed or (sub-)advised by US managers.

UCITS (Undertakings for Collective Investment in Transferable Securities, investment vehicles established under Directive 2001/107/EC and 2001/108/EC) are basically the EU equivalent of US mutual funds. They form a sector of the European asset management industry that is valued at approximately €9.0 trillion. Quite a number of UCITS are either managed or (sub-)advised by US fund managers. There is some concern that the new UCITS V Directive, discussed below, might make it more cumbersome to implement this "work-sharing scheme."

UCITS V

The European Parliament and Council reached agreement on the substance of the new UCITS V rules on February 25, 2014. These new rules will include safeguards to protect client assets in the event of a depositary's insolvency. Under the February 25 agreement, depositaries will be liable for any loss of UCITS assets held in custody, while clients will also have the right of redress against the depositary. Only national central banks, credit institutions and regulated firms with "sufficient capital and adequate infrastructure" will be eligible as UCITS depositaries.

Remuneration Rules. . .

The UCITS V framework also addresses remuneration practices that are thought to encourage excessive risk-taking and aims to align UCITS compensation with the AIFMD provisions. The agreement provides that as of 2016, 50 percent of the variable portion of the remuneration of the individuals responsible for managing or advising the relevant UCITS fund will have to be paid in shares of the managed UCITS fund; in addition, 40 percent of that variable portion must be deferred for at least three years. The agreement further provides that 60 percent of the variable portion of any very high bonuses will have to be deferred. The European Securities and Markets Authority (ESMA) should prepare guidelines as to whom the pay policy applies.

Are these remuneration rules sound? The German financial services supervisory authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin)), for example, published rules on remuneration for investment firms in early 2014. These rules provide that separate compliance personnel must monitor, control and change, where necessary, remuneration systems implemented by the employer.

The German Banking Act, which applies to credit institutions, focuses on so-called risk takers in connection with monitoring sound remuneration policies. The bonuses of risk takers must be deferred for a period of five years. This approach is believed to reduce the likelihood that risk takers in credit institutions will take great risks to increase their bonuses at the ultimate expense of the institution. Deferring bonus payments is expected to ensure that the personal risk exposure of the risk takers matches the risk profile set by the credit institution’s senior management. Although analogous in purpose, these Banking Act provisions do not relate directly to UCITS. Nevertheless, they might be relevant where a credit institution’s employees (sub-)advise UCITS funds.

ESMA has also published guidelines on sound remuneration systems under AIFMD for investment fund managers.

All these initiatives are based on the premise that deferred remuneration systems should be implemented by the relevant institutions to avoid conflicts of interests and ensure sound and sustainable business models. They rely heavily on the implementation of new incentive and compliance frameworks.

. . .and the US Fund Manager

There is some concern that the UCITS V remuneration restrictions could make it difficult for US-affiliated advisers and managers to manage UCITS. Non-EU managers will not be exempt from these rules merely by virtue of their location. This issue was lobbied fairly intensively, but obviously to no avail.

The requirement for managers to receive half of their bonuses in units of the fund they manage is potentially problematic because the offering documents for many UCITS limit the ability of US persons to own shares of UCITS funds.

Last-minute agreements on the substance of the Directive state that the rules should apply to “any third parties to whom functions have been delegated,” including non-EU-based investment advisers to UCITS funds. US fund groups had hoped that they would be able to pay bonuses in shares of the parent company sponsoring the UCITS fund, but the February 25 agreement rules that out. Shares of the parent company, some politicians argued, would reward fund managers for increasing the profits of the sponsor rather than the value of the fund they manage.

It is not at all clear, however, that US-affiliated advisers and managers will necessarily be so negatively affected. The offering documents of many UCITS funds limit, but do not prohibit, sales to US persons. Rather, they make sure that the sales to US persons are made in private offerings, rather than public ones, and, as a general matter, that US investors satisfy certain asset requirements as well as certain numerical and other limitations. Such limitations satisfy requirements under the US Securities Act of 1933 and the US Investment Company Act of 1940. Moreover, some EU affiliates of US entities are not treated as US persons in the first place under the offering restrictions. In addition, it would appear that the exemption for non-US public funds found in the recently adopted Volcker Rule would allow even advisers and managers affiliated with banks to hold shares in UCITS in amounts that would comply with UCITS V.

Further Procedure

The agreed text of the Directive must be voted on by the European Parliament and approved by the Council. A vote in the European Parliament may be scheduled before the European elections in late May 2014. EU member states have an additional 18 months to transpose the Directive into national law.

ESMA will publish guidelines on the scope of the Directive within the next six months. These guidelines could partly ease the situation for non-EU fund managers, but the European Parliament and the European Council have stated that the guidelines should “prevent circumvention of the provisions on remuneration.”

Conclusion

From an institutional point of view, deferred remuneration systems will require credit institutions, as well as investment firms and custodians, to ensure sound and sustainable business models that also protect the public. This will be accomplished in part by establishing incentives and compliance systems that foster a risk-aware approach and an awareness by employees that they will profit only if the fund investors or the relevant credit institutions do. UCITS offering materials will need to be evaluated to see if current advisory structures can be maintained while retaining the desired business profile of the fund.

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