Deloitte.

Link'n Learn
UCITS developments

24 April 2014

Leading business advisors

Your presenters today

Martin Bock

Director – Enterprise Risk Services
Deloitte Luxembourg
mabock@deloitte.lu
+352 45145 2127

Patrick Rooney

Senior Manager – Investment Management Advisory
Deloitte & Touche Ireland
prooney@deloitte.ie
+353 1 417 2962

Agenda

Evolution of UCITS

Evolution of UCITS

UCITS Directives over time

1985

UCITS I

- Retail framework
- Open-ended
- Transferable securities
- EU passport

2001

UCITS III

- Extension of eligible assets to include money market instruments, derivatives, units of other funds, financial indices
- New risk management process (RMP)
- Eligible assets clarifications in 2007

2008 Financial crisis

2009

UCITS IV

- Simplified regulator-to-regulator passport notification and cooperation
- Management company passport
- Master-feeder structures
- Cross-border mergers
- Key investor information document (KIID)

2014(e)

UCITS V

- Harmonised depositary functions – oversight, safekeeping and cash monitoring
- New standard of depositary liability
- Rules on remuneration covering policy, governance and bonus payments (including deferral and clawback)
- EU-wide sanctions rules and whistle-blower mechanism

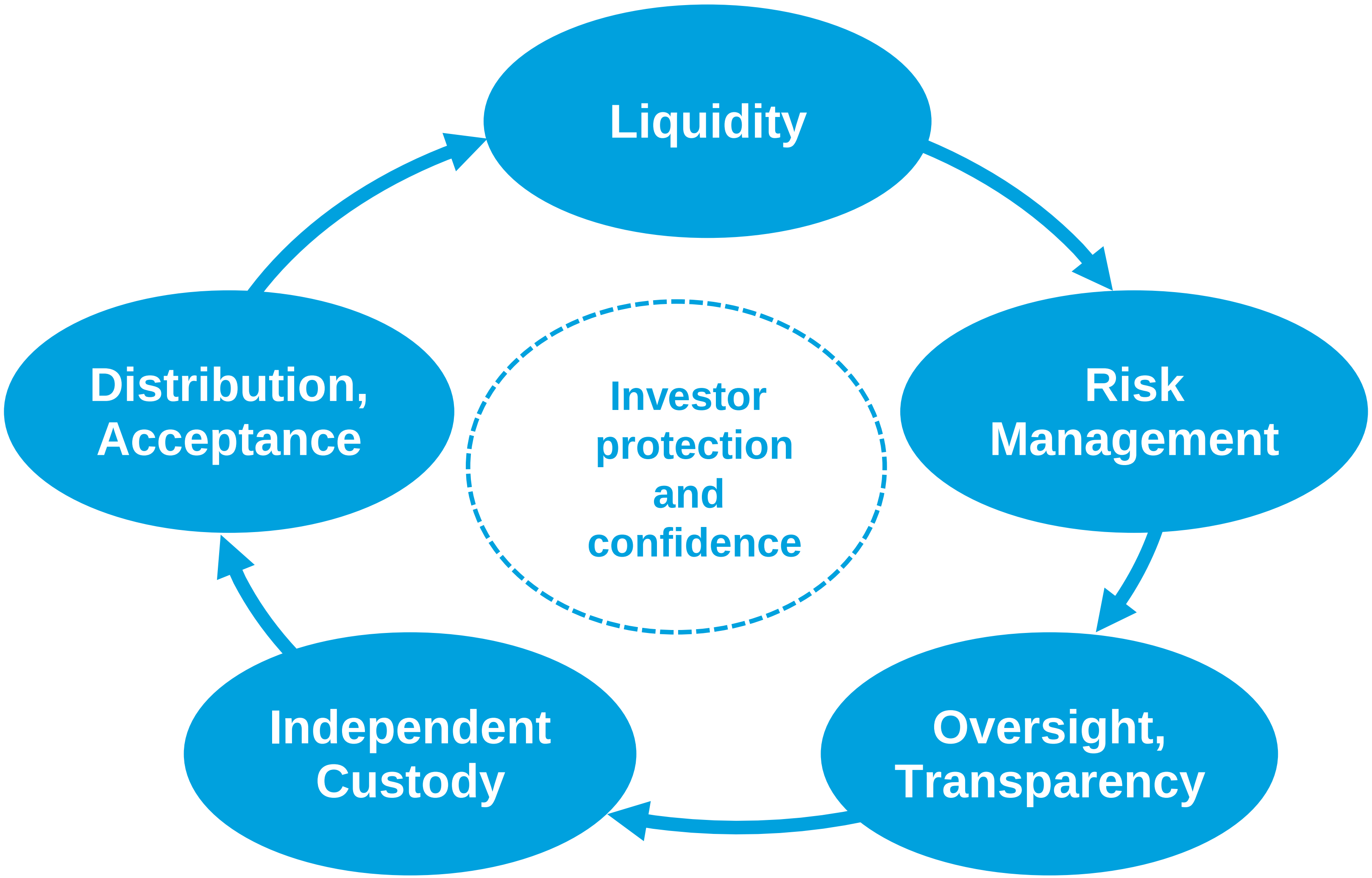
2015(e)

UCITS VI

- Review of 'eligible assets'
- Review of 'efficient portfolio management' techniques
- Review of OTC derivatives practices
- Review of liquidity management
- Depositary passport?
- Addressing UCITS V / harmonisation with AIFMD?
- Monet market funds (separate MMF Regulation)
- Long –term investments (ELTIFs)

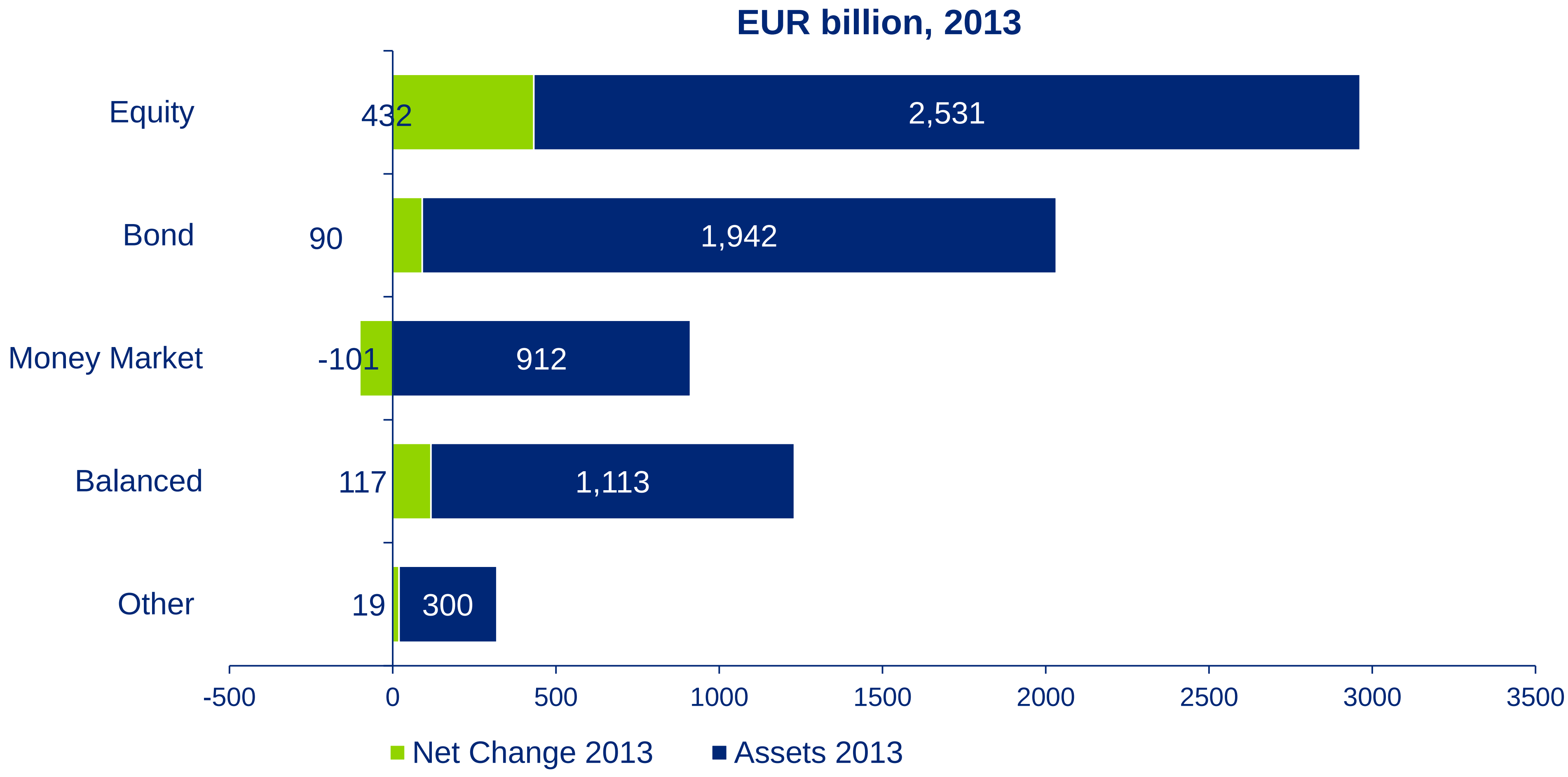
Evolution of UCITS

Key features



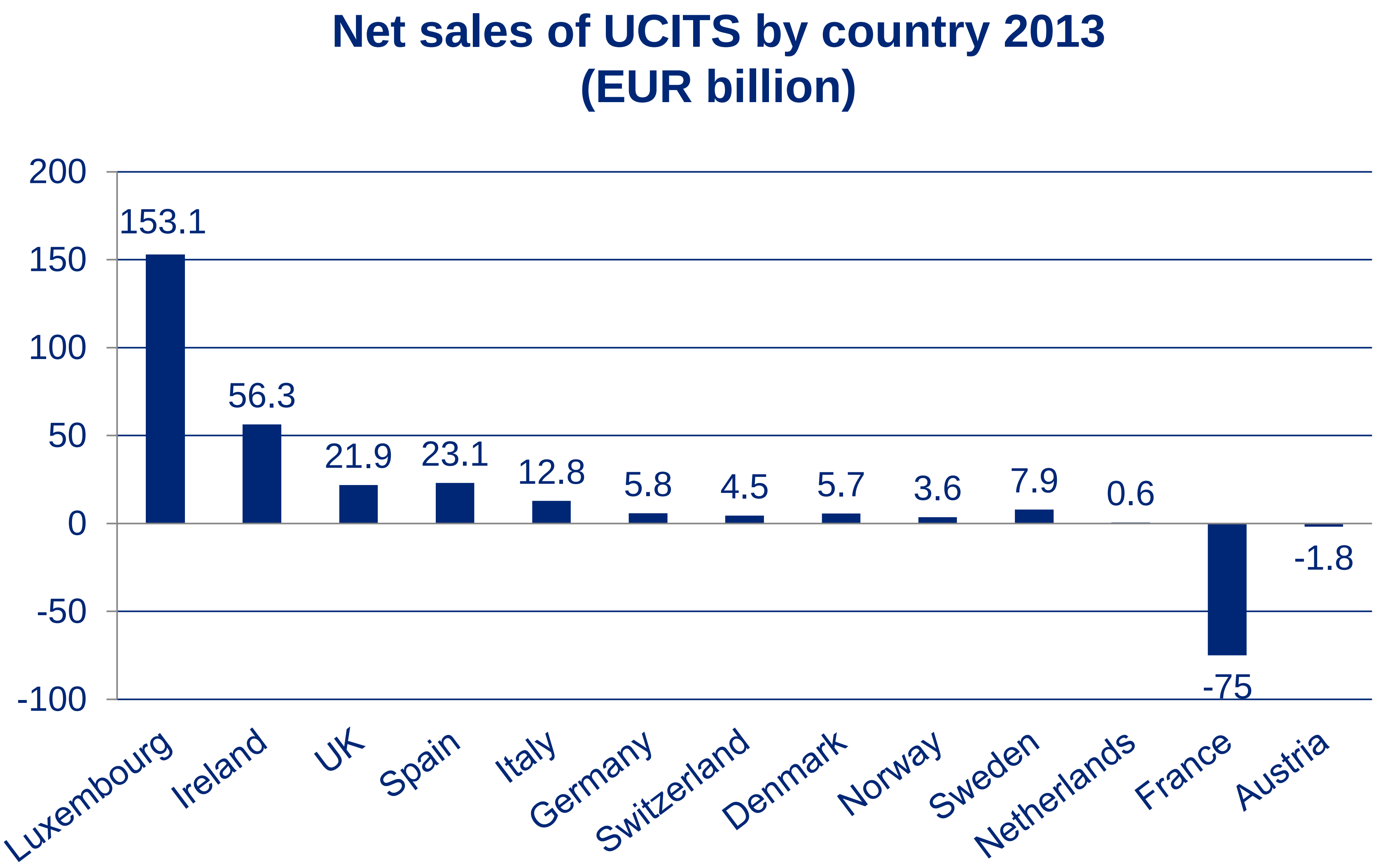
UCITS net sales

Net sales by asset type



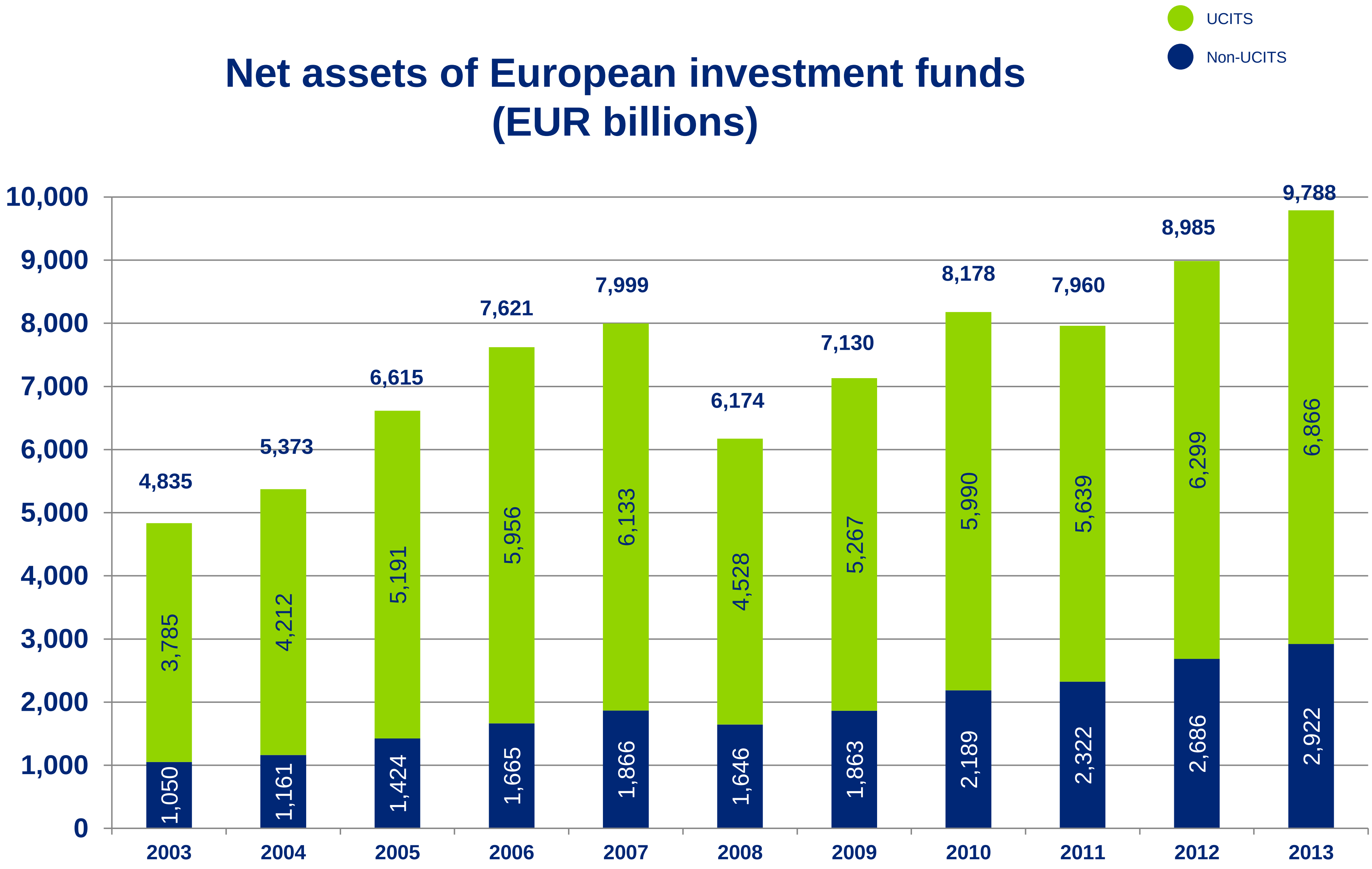
Source: EFAMA, Q4 2013

UCITS net sales



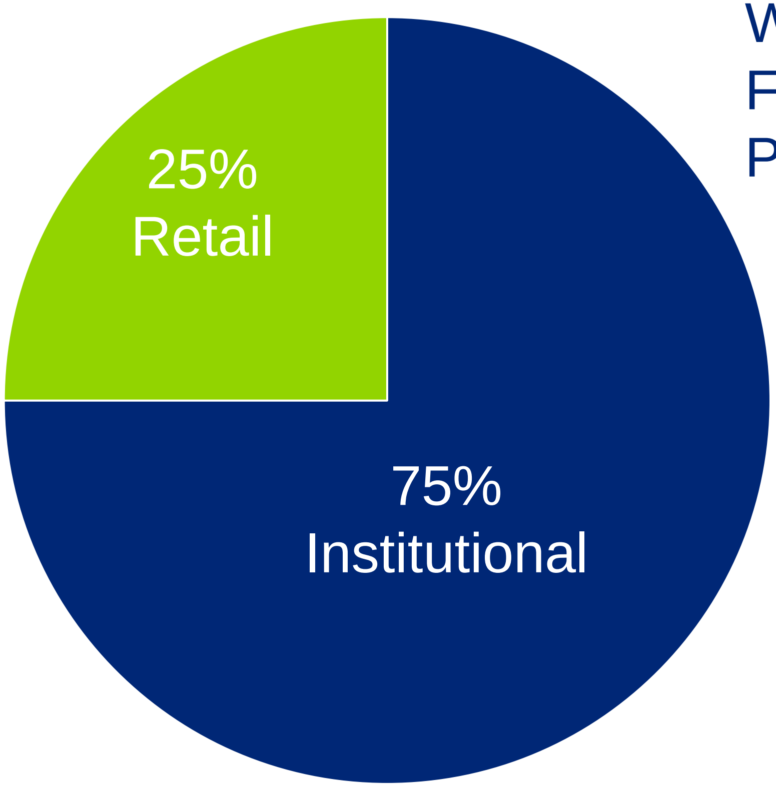
Source: EFAMA, Q4 2013

Evolution of UCITS

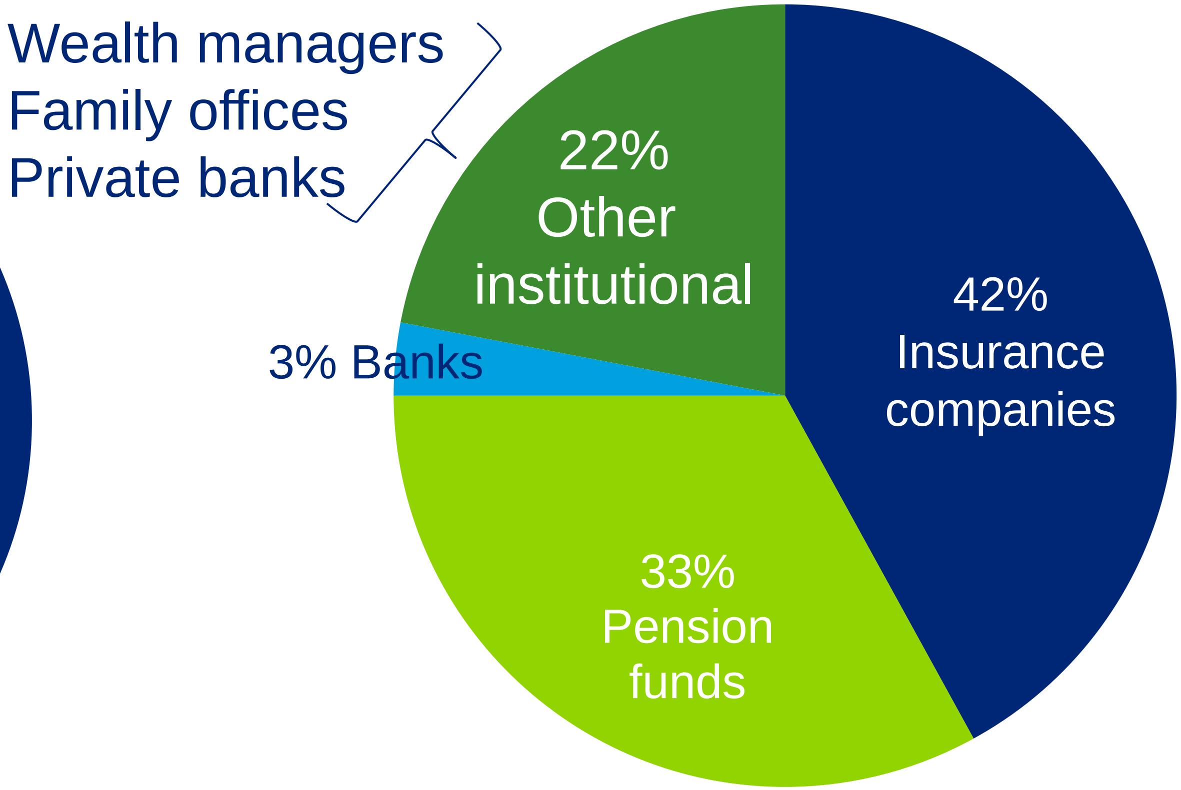


Evolution of UCITS

Alternative UCITS investor base
(by % of assets)



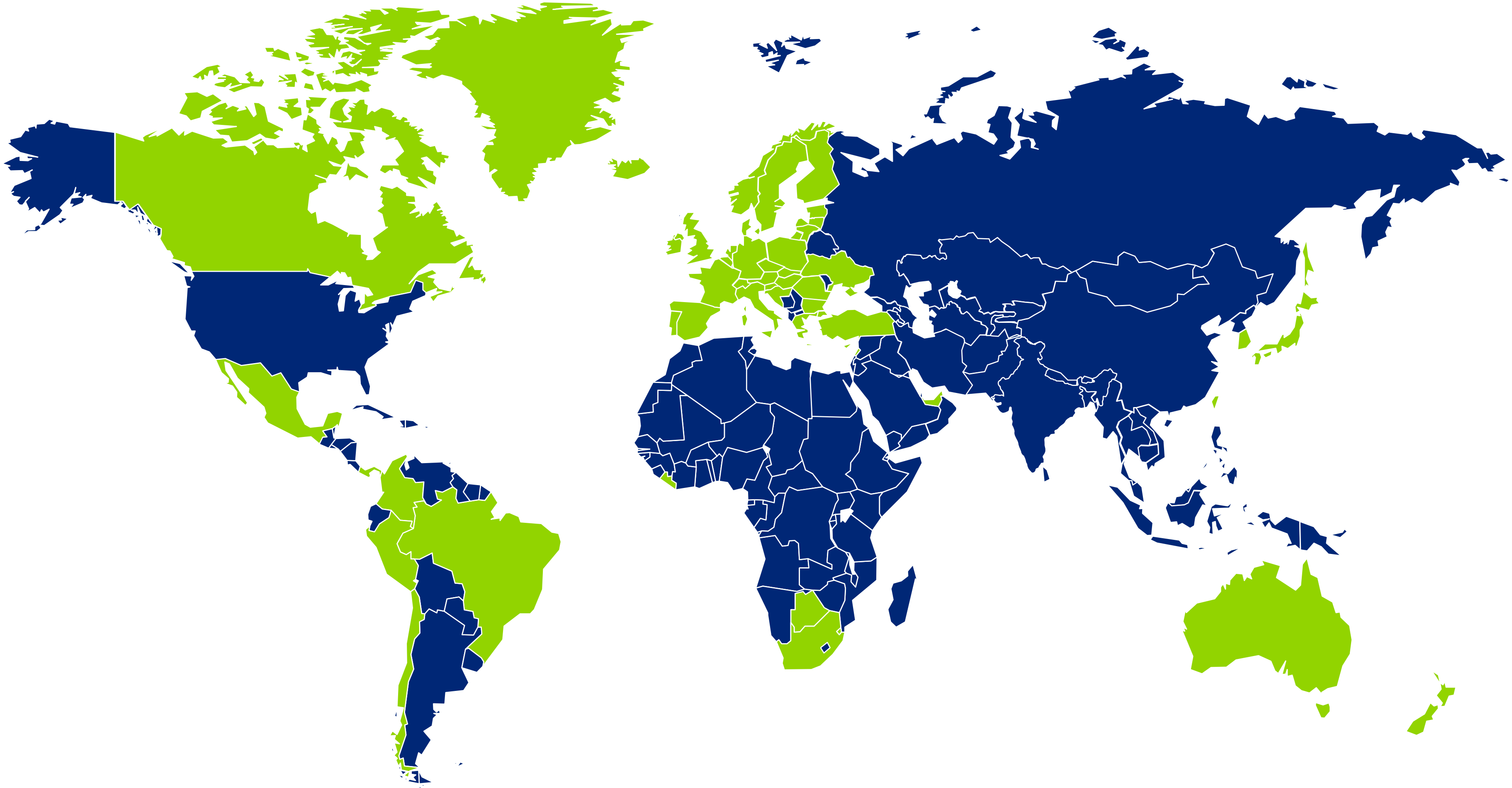
European institutional investor base
(by % of assets)



Source: EFAMA Asset Management Report, 2013

UCITS

A global brand



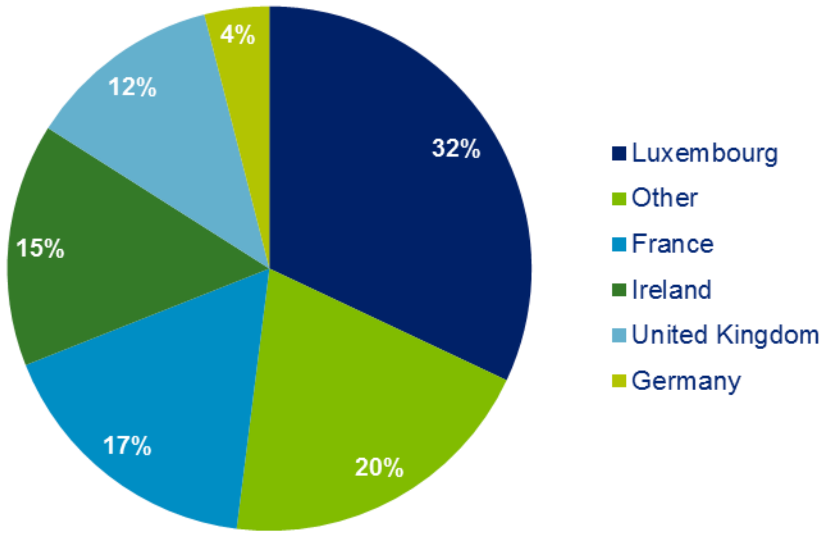
Luxembourg and Irish UCITS are registered for sale in over 70 countries

Source: Deloitte analysis

UCITS

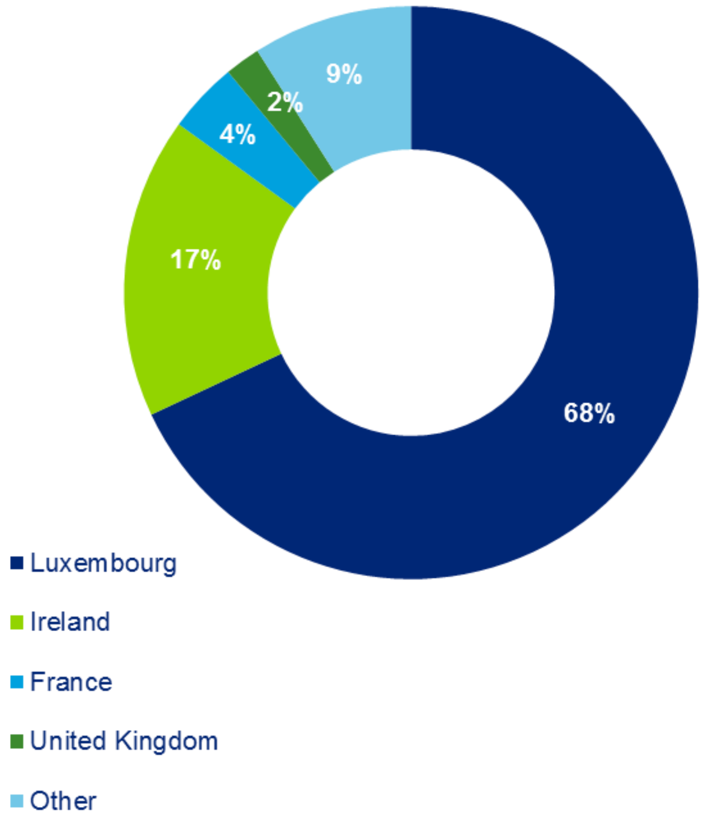
A global brand

Top 5 European UCITS Markets
(Nets assets in mio euro at end Q2 2013)



Source: EFAMA / Deloitte analysis

Domicile Share of Authorizations for Cross-Border Distribution



Source: Lipper/Deloitte analysis

UCITS V

UCITS V

UCITS V puts the focus on asset safety, investor protection, pay and bonuses and penalties for rule-breaking following the financial crisis and incidents such as Madoff and Lehman Bros.

Jul 2012	Jul 2013	Dec 2013	April 2014	Late 2015
Commission proposal	EP vote (Key ECON changes rejected)	Council adopts its position	Adopted	Expected Implementation

1 Remuneration

- Aligned with the remuneration rules under AIFMD
- Policy, governance, review
- Rules on bonuses
- Avoid rewarding failure and protect investor interests

2 Depositary

- Lack of harmonisation in depositary duties and liability highlighted during the crisis
- Make the depositary liable for loss in almost all cases
- Rules aligned with AIFMD, clarifying new safekeeping (including strict liability), oversight and cash monitoring duties

3 Sanctions

- Divergent approaches and penalties across member states in relation to sanctions under the UCITS Directive
- Harmonise the approach to sanctions and penalties
- Penalties include public reprimands, fines, temporary suspensions and permanent bans

UCITS V

Remuneration

Remuneration governance	• UCITS management companies must implement remuneration policies and practices which promote sound and effective risk management and do not encourage excessive risk-taking • Policy must be adopted by the management body and reviewed at least annually • Larger management companies will need to establish a remuneration committee • Pension policy should be in line with business strategy, objectives, values and long-term interests • Rules for payments related to termination of employment (should not reward failure)
Which staff are in scope?	• Senior management, those on the pay equivalent to senior management, decision takers, risk takers, control functions, persons who have an impact on the risk profile • Recital states that categories of staff should include: *"any employee and any other member of staff at fund or sub-fund level who are decision takers, fund managers and persons who take real investment decisions, persons who have the power to exercise influence on such employees or members of staff, including investment advisors and analysts"* • The remuneration rules should also apply "in a proportionate manner" to delegates that impact on the risk profile of the UCITS. • ESMA will issue remuneration guidelines to specify applicability to delegates and to employees subject to different sets of remuneration requirements (AIFMD, CRD, MiFID)
ManCo remuneration	• The principles regarding sound remuneration policies should also apply to payments made by the UCITS itself to management companies • The total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the management company or of the UCITS concerned occurs

UCITS V

Remuneration

Key bonus rules	• Guaranteed variable remuneration should only be exceptional and limited to the first year • At least 50% of variable remuneration should comprise of units of the UCITS or equivalent ownership interests (unless the management of UCITS accounts for less than 50% of the total portfolio managed by the management company) • At least 40% of variable remuneration should be deferred over a period which is appropriate “in view of the holding period recommended to investors” and for a period of at least 3 years • Variable remuneration should be subject to overall financial performance and downward adjustment by way of malus (pre-vesting) or clawback (post-vesting) adjustments
Proportionality	• ESMA to issue guidelines on the application of the remuneration framework, taking into account management company size, internal organisation, and the nature, scale and complexity of activities as well as aligning to the extent possible with AIFMD
Disclosure	• Details of the remuneration policy should be included in the prospectus or the prospectus should provide a website reference to a summary of the remuneration policy. The KIID should also include a statement on remuneration referring to a website for further details • The annual report disclosure on aggregate fixed and variable pay and remuneration broken down by various categories of staff should also include a description of how remuneration benefits have been calculated and the outcomes of the remuneration policy reviews

UCITS V
Depositary

Depositary liability	• Strict depositary liability for financial instruments that can be held in custody • In the case of loss anywhere in the sub-custody network, the depositary must return an identical asset (or cash equivalent) to the UCITS without undue delay • The depositary is liable unless it can prove otherwise; that there was an external event beyond its reasonable control • No possibility to contractually discharge liability as under AIFMD • Investor’s right to invoke a claim against the depositary
Other duties	• Ownership verification and record-keeping duties for “other assets” not subject to strict liability, e.g. OTC derivatives • Harmonise depositary oversight duties between different legal structures • Restriction of delegation to safekeeping duties only • Requirements on sub-custodian segregation of assets, reuse of assets (securities lending) subject to strict conditions • Monitoring of all cash flows
Depositary eligibility	The depositary may be a: • A credit institution • A national central bank • Another legal entity authorised by member states that is subject to ongoing supervision as well as minimum capital, prudential and organisational requirements

UCITS V

Sanctions

- Member states are required to lay down rules on administrative sanctions that should be "effective, proportionate and dissuasive"
- UCITS V sets out broad categories for UCITS breaches for which national regulators must provide penalties
- A member state may also decide not to lay down rules for administrative sanctions for breaches which are subject to national criminal law.
- Commission review of progress within 4 years and report on progress made and the need for further harmonisation

ESMA role	• National regulators must report information on sanctions they have issued to ESMA • ESMA will publish aggregated information on such sanctions in its annual report • ESMA is empowered to set up a European-wide whistle-blower mechanism for the reporting of breaches on national rules implementing UCITS
Penalties	• A public statement which identifies the person responsible and the nature of the breach • A temporary suspension or permanent bans for repeated and serious breaches • Maximum fines of at least €5 million or 10% of annual turnover for companies and maximum fines of at least €5 million for individuals

UCITS VI

Key concerns leading to reforms

Complexity

- Retailisation of complex products – lack of understanding/knowledge among investors
- Investors may not understand the full impact of the UCITS rules on the implementation of the investment strategy
- Mis-selling; unclear about the risks/exposures

Information deficit

- Lack of clarity on treatment of index tracking errors
- As the information is proprietary, there can be a lack of transparency
- Allocation of collateral / proceeds from securities lending

Counterparty concerns

- Credit risk of SPVs / counterparties
- Securities lending risk from borrower default

Liquidity concerns

- Liquidity bottlenecks during the financial crisis with investors unable to redeem
- Risk of investor 'runs', particularly in relation to money market funds

ESMA's guidelines on ETFs and other UCITS issues

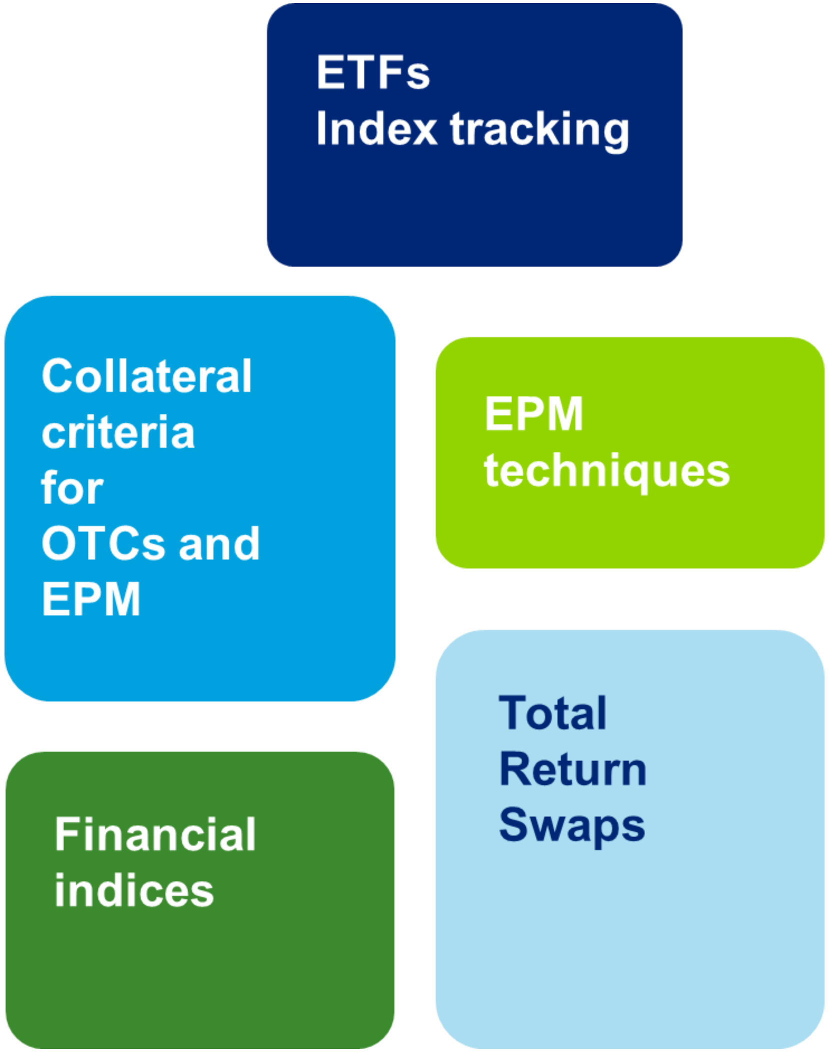
Recent clarifications

Collateral diversification rule

- The guidelines took effect on 18 February 2013 with 12 month transitional arrangements for certain requirements
- The guidelines state that there must be a maximum exposure of 20% of NAV to a single issuer with respect to collateral received for the purposes of efficient portfolio management (EPM techniques and OTC derivative transactions
- ESMA issued a report on 24 March 2014 which provides an exemption from the 20% collateral diversification rule for **government securities**
- The exemption is **available to all UCITS** rather than just money market UCITS, as previously proposed
- UCITS availing of the exemption should instead receive securities from at least six different issues, but securities from any single issue should not account for more than 30 % of the UCITS NAV. New disclosure requirements in the prospectus and annual report also apply to UCITS availing of the exemption

Annual report EPM revenue disclosure

- ESMA's guidelines require disclosure in the annual report of revenues arising from EPM
- The Central Bank of Ireland has confirmed that a "reasonable interpretation" would be to include only revenue from securities lending arrangements and repurchase/reverse repurchase agreements and not gains on share class hedging



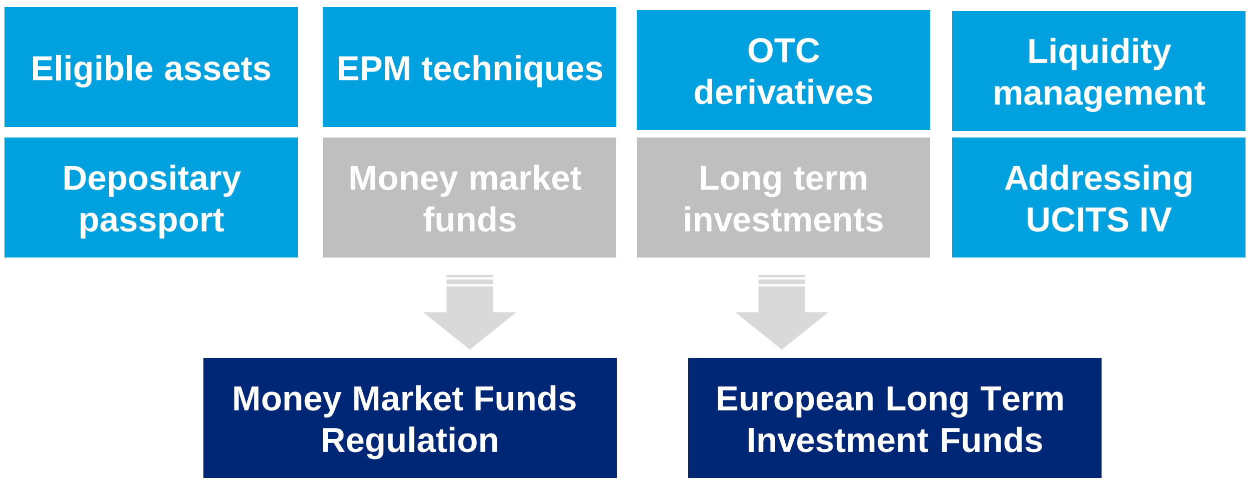
UCITS VI

Rolling back complexity?

Overview

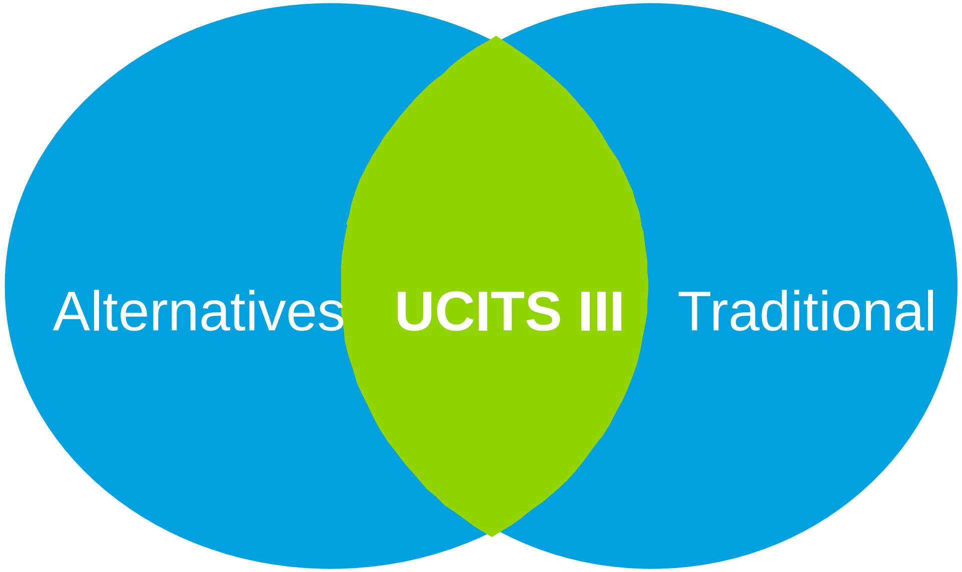
- Very open-ended consultation launched on 26 July 2012 covering eight wide-ranging areas
- Dubbed “UCITS VI” as it was seen as the basis for a further set of reforms to the UCITS framework
- Since that consultation paper, two areas (money market funds and long-term investments) have been addressed separately outside of the UCITS framework
- The delay in adopting UCITS V has undoubtedly impacted further progress on UCITS VI, which has yet to issue as a formal proposal

Areas covered in the original “UCITS VI” consultation



UCITS VI

Rolling back complexity?



Eligible assets

- The Commission expresses concern over the appropriateness of sophisticated investment strategies for UCITS and is considering a review of eligible assets
- A “look though” approach for transferable securities, investments in financial indices or closed-ended funds is proposed
- Distinguishing or limiting the scope of eligible derivatives based on the payoff is considered. While the term “exotic derivative” is used no definition is provided
- Moving away from VaR as a method of global exposure and relying solely on the commitment approach is proposed
- The paper considers permitting in UCITS only derivatives which are traded on multilateral trading platforms and cleared through a Central Clearing Counterparty (CCP)

UCITS VI

Rolling back complexity?

Efficient portfolio Mgmt.	• Efficient portfolio management (EPM) techniques relate to activities such as securities lending and repos and reverse repos • A UCITS is not permitted to borrow or lend but the Commission is concerned that certain EPM activities are the equivalent of borrowing or lending • The Commission is concerned with the transparency, counterparty risk, quality of collateral and re-investment of collateral associated with EPM techniques • The consultation considers making EPM transactions recallable at any time • The consultation considers putting a limit on the amount of portfolio assets that may be the object of EPM
OTC derivatives	• The Commission is concerned about a UCITS exposing its entire portfolio to a single OTC derivative counterparty, which can happen if that counterparty provides collateral for more than 90% of the exposure of the UCITS • The paper points out that while there is a requirement to calculate global exposure on a daily basis there is no corresponding requirement to calculate OTC counterparty risk and issuer concentration daily
Liquidity Mgmt.	• The Commission is concerned about liquidity challenges during the financial crisis, when investors were unable to redeem • The Commission is considering defining “exceptional cases” when it would be appropriate to place a temporary suspension on redemptions • The Commission wants to consider the use of “extraordinary liquidity management tools” such as side pockets and is also concerned about ensuring sufficient liquidity in secondary markets for ETF investors

UCITS VI

Depositary passport

- AIFMD and UCITS V will harmonise EU depositary rules and therefore possibly create the basis for an EU depositary passport
- The Commission has sought views on the advantages and drawbacks for the creation of EU passport for depositaries

Advantages

- Increased efficiencies
- Economies of scale
- Lower depositary fees?
- Centres of excellence
- Global operating model

Drawbacks

- Loss of local expertise?
- Risk of applying local rules incorrectly?
- Less robust oversight
- Increased concentration in the market
- Tax residency implications for contractual UCITS?

UCITS VI

Addressing UCITS IV

UCITS IV Tidy-up	
UCITS IV Tidy-up	• The Commission is seeking to be empowered under the UCITS Directive to adopt delegated acts with respect to self-managed investment companies with a view to harmonising requirements with those applicable to UCITS management companies • Some 'tidy up' measures are also proposed, including application of the same information standards in all master-feeder scenarios, improvement of notification procedure between member states and increasing legal certainty around the 20 working day time limit for notification for cross-border mergers

Further harmonisation with AIFMD?

- Some of AIFMD's provisions are more detailed: organisational rules, delegation, risk and liquidity management, valuation, reporting or calculation of leverage
- The Commission is considering whether further alignment between UCITS and AIFMD is necessary to improve consistency

Other topics impacting UCITS

PRIIPs

Packaged retail and insurance-based investment products

Jul 2012	April 2014	2016	2019	2019
Commission proposal	**Approved**	**Requirement to prepare a KID**	**End of transition for UCITS**	**Commission review**

The Key Information Document

- The Key Information Document (KID) aims to provide clear and comparable information about products to aid consumers in decision making and prevent mis-selling
- UCITS already has a Key Investor Information Document (KIID) which will eventually be replaced by the new industry-wide KID after a transitional period of four years
- The KID is applicable to manufacturers of PRIIPs and to persons advising or selling PRIIPs in banking, insurance, securities and funds sectors (some exemptions apply)
- Should be easy to understand, written in the official language (or another accepted language)
- To be provided in good time before the transaction – may be provided electronically but hard copy must be an option
- Liability for misleading/false information and ability of the investor to make a claim for damages
- Regulators will have new product intervention powers under MiFID/PRIIPs and also sanctioning powers in relation to the KID

Comprehension Alert

A “comprehension alert” must inform the retail investor of investment products that may be difficult to understand. The criteria for being difficult to understand are:

a) The product invests in underlying assets that are not commonly invested in by retail investors
b) The product uses a number of different mechanisms to calculate the final return
c) The investment’s pay-off takes advantage of the retail investor’s behavioural biases, such as a teaser rate followed by a much higher floating conditional rate

PRIIPs KID versus KIID comparison

KID (across all retail products)

- **Length:** No more than 3 slides of A4 pages
- **Comprehension Alert:** Yes
- **Synthetic risk indicator:** Yes

- <u>**Headings:**</u>

1. **"What is this product?"** covering the type of PRIIP, a description of the consumer target and ability to bear loss, details of any insurance benefits and the term of the PRIIP
2. **"What are the risks and what could I get in return?"** including a synthetic risk indicator and information on the possible maximum loss of invested capital
3. **"What happens if the [name of PRIP manufacturer] is unable to pay out?"** including a brief description of whether the related loss is covered by a compensation or guarantee scheme and if so, the name of the guarantor and which risks are covered
4. **"What are the costs?"** covering both direct and indirect costs to be borne by the investor, including summary indicators of these costs.
5. **"How long should I hold it and can I take money out early?"** including information on any cooling off or minimum holding period, penalties for early disinvestment the potential consequences of cashing the PRIIP before the end of the term or recommended holding period
6. **"How can I complain?"** covering information about how and to whom an investor can make a complaint
7. **"Other relevant information"** including a brief indication of any other documentation to be provided to the investor (excluding any marketing material)

KIID (UCITS only)

- **Length:** No more than 2 slides of A4 pages
- **Comprehension Alert:** No
- **Synthetic risk indicator:** Yes

- <u>**Headings:**</u>

1. **"Objectives and Investment Policy"** covering a joint description of the objectives and policy of the UCITS in plain language. To include the essential features of the UCITS which a typical investor should know and other information if relevant
2. **"Risk and Reward Profile"** including a synthetic risk indicator and narrative presentation of risks materially relevant to the fund which are not adequately captured by the indicator
3. **"Charges for this Fund"** inclusion of a table specifying the entry, exit and ongoing charges with a narrative explanation of the charges
4. **"Past Performance"** including a bar chart presenting the past performance of the UCITS over a 10 year period and supplementary information
5. **"Practical information"** including the name of the depositary, statement on the liability of the management company, tax information, information on the umbrella/share classes, where and how to find further information

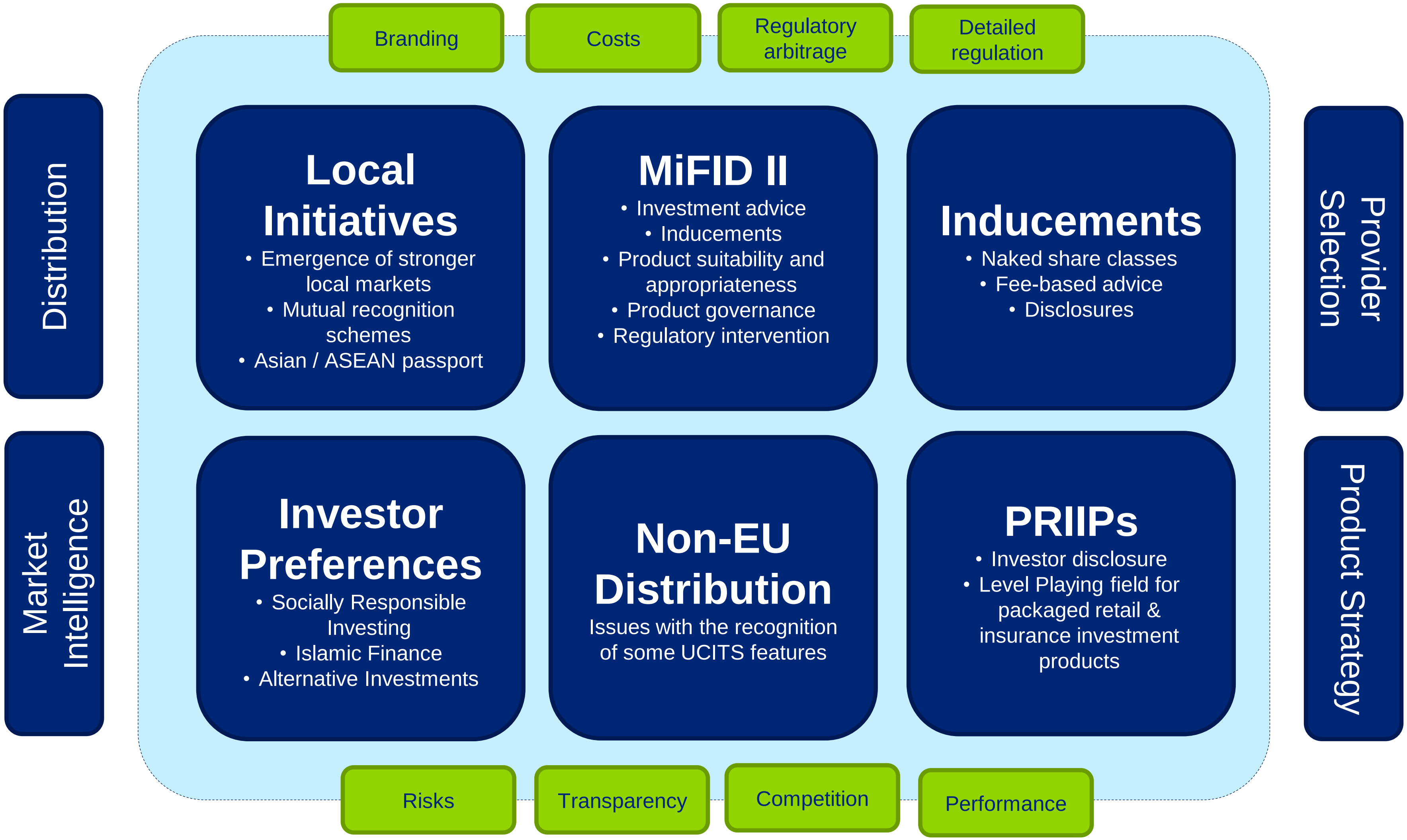
MiFID II

Investor protection initiatives impacting UCITS

Investment advice	• Investment advisers must clarify whether advice is provided on an 'independent' basis. • Independent advice needs to be based on an assessment of a sufficient range of products not limited to those from firms with which the advisor has close links or an economic relationship which could impair the independence of the advice
Inducements	• Independent investment advisers are banned from **retaining** fees, commissions or any monetary and non-monetary benefits
Product governance and intervention	• Product approval processes should specify a target market and assess all risks relevant to the target market and the appropriateness of the distribution strategy • MiFIR sets out powers for national regulators, in coordination with ESMA/the EBA, to ban products permanently, while giving ESMA/the EBA the ability to also ban products temporarily
Suitability and appropriate-ness	• New appropriateness and suitability test for complex products, e.g. structured UCITS are now classified as complex. Such products can therefore no longer be sold on a non-advised basis • Advisors must indicate whether they will conduct a periodic assessment of the suitability of the product for the client • Retail clients must receive a written statement on product suitability before the transaction • Investment firms must provide clients with reporting on the service being provided, taking into account complexity and costs
Bundled packages	• Disclosure rules apply when an investment service is offered together with another service or product as a package • Where packages compare unfavourably, this will be more transparent to consumers • The appropriateness of an overall bundled package must be taken into account in assessing suitability

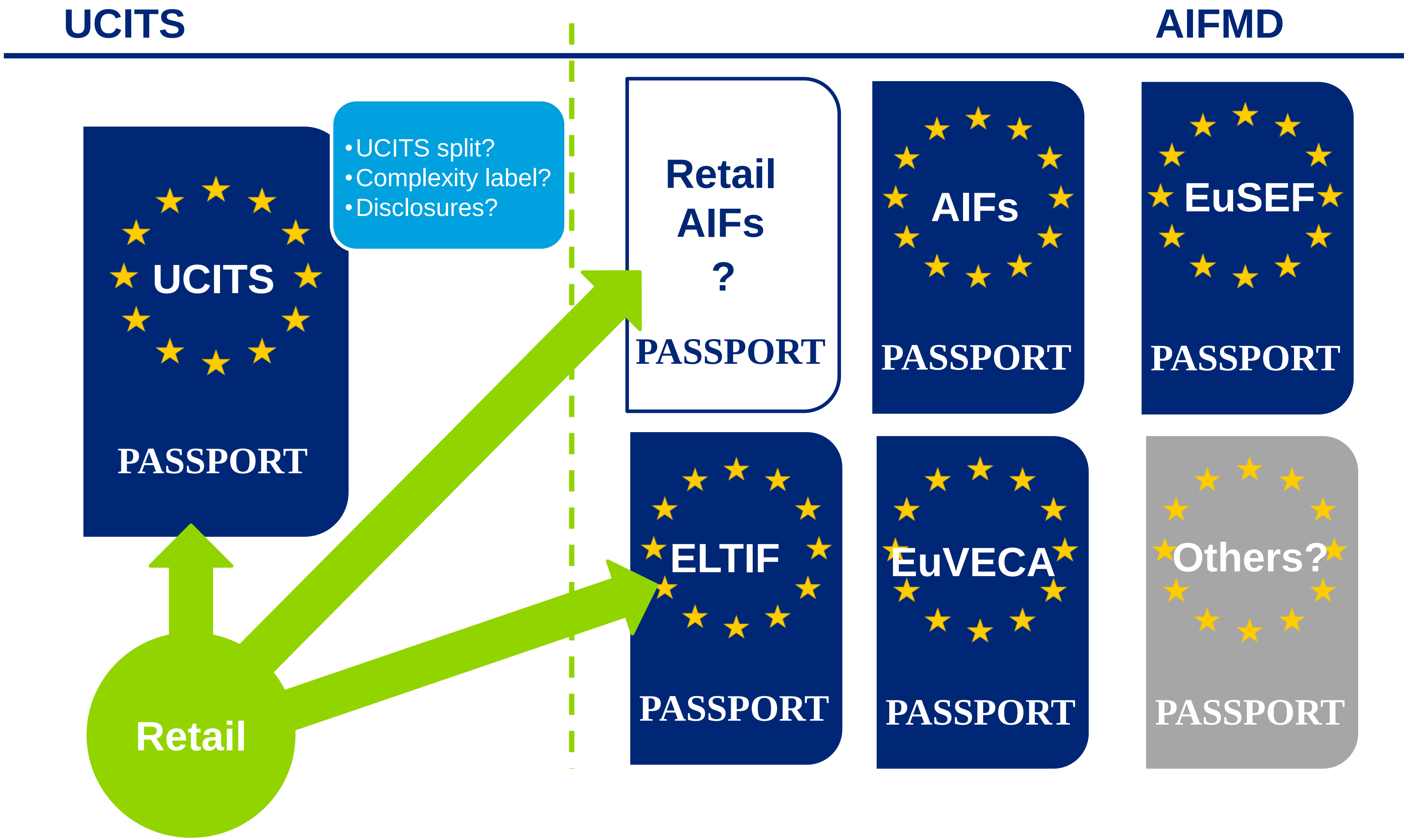
Forces at work

Product design and distribution in a changing world



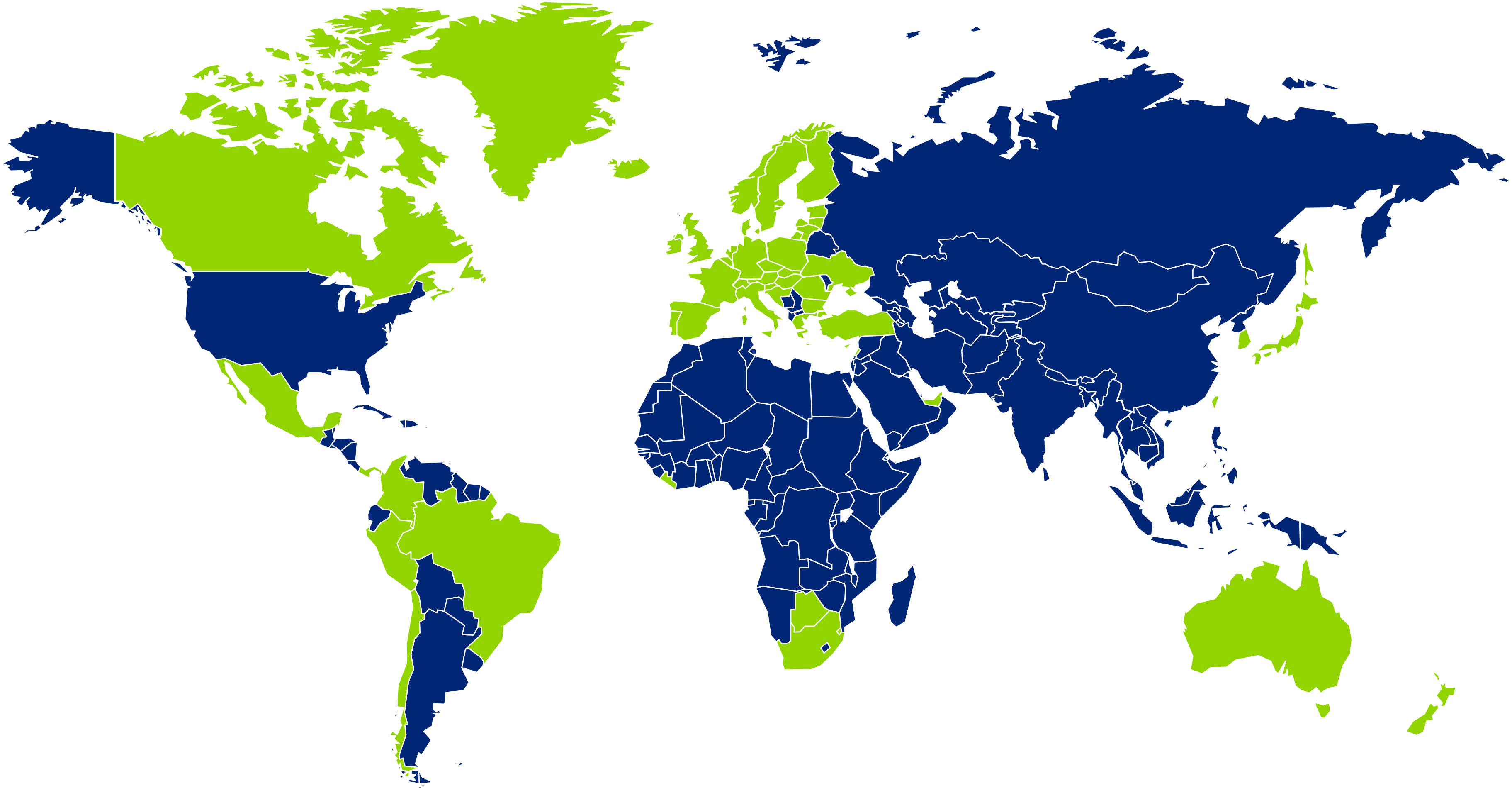
UCITS future landscape

Future landscape



UCITS

A global brand



€8.9 trillion AuM in 35,618 funds*

*Source: EFAMA, Q4, 2013

Source: Deloitte analysis

Thank you

Martin Bock

Director – Enterprise Risk Services
Deloitte Luxembourg
mabock@deloitte.lu
+352 45145 2127

Patrick Rooney

Senior Manager – Investment Management Advisory
Deloitte & Touche Ireland
prooney@deloitte.ie
+353 1 417 2962