Link’n Learn

UCITS V and UCITS VI update

5 March 2015

Leading Business Advisors

Contacts

Aisling Costello
Senior Manager – Investment Management Advisory
Deloitte & Touche Ireland
E: acostello@deloitte.ie
T: +353 1 417 2834

Tom Renders
Senior Manager – Audit
Deloitte Belgium
E: trenders@deloitte.com
T: + 32 2 800 20 57

Agenda

- UCITS market overview
- UCITS VI
- UCITS V
- ESMA’s consultation on different share classes
- Depositary independence
- Guidelines on ETFs and other UCITS issues
- PRIPS & KID

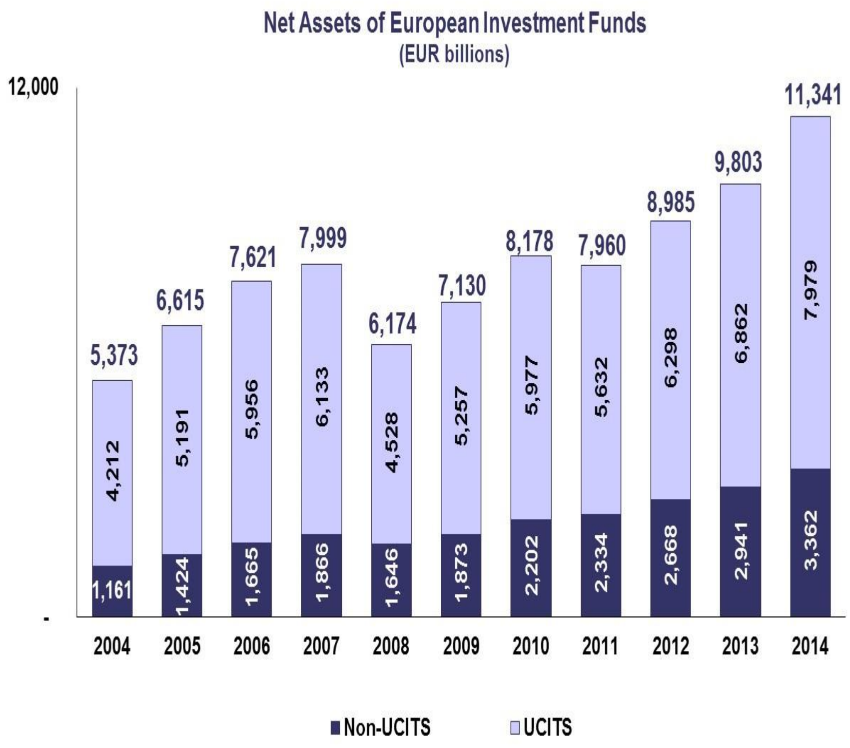
UCITS market overview

Market overview

2014 was a record year for the European investment fund industry. Net sales of European investment funds rose to an all-time high of EUR 634 billion in 2014 and assets under management broke through the EUR 11 trillion mark thanks to a growth rate of 16%. This was all achieved despite sluggish growth, deflationary threats and geopolitical tensions in Europe. The overall positive outcome can be explained by four key factors:

- ✓ the quest for investment returns in a context of very low interest rates
- ✓ the attractiveness of investment funds in terms of investor protection,
- ✓ the great variety of investment strategies and risk-return profiles available in the investment fund market, and
- ✓ the role of central bank actions to prevent deflation and foster economic growth.

Bond funds attracted the largest net inflows as investors continued to expect long-term interest rates to fall further. Equity funds recorded lower net sales compared to 2013 against the background of a gloomy economic outlook and volatile stock markets. In this uncertain macroeconomic environment, the demand for balanced funds soared to a record level as the asset diversification and risk reduction offered by this type of fund continued to attract many investors. On the other hand, money market funds suffered net withdrawals, albeit much less pronounced than in 2013. This confirms the view that many European businesses and institutions use money market funds as a short-term cash management tool even if they offer close-to-zero returns.

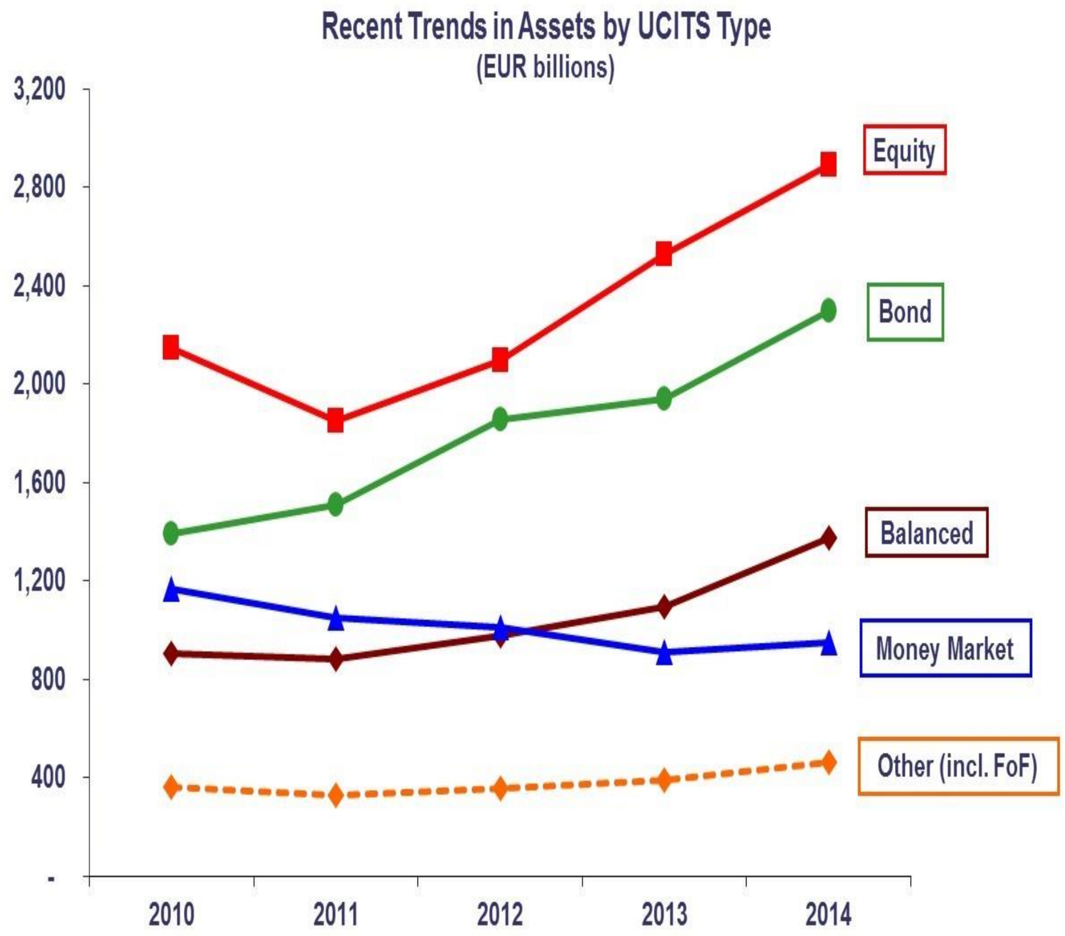


Source: EFAMA

Market overview

Further highlights on the developments in 2014 include:

- Investment fund assets in Europe increased by 15.7 percent to EUR 11,341 billion: overall, net assets of UCITS increased by 16.3 percent to EUR 7,979 billion. Net assets of non-UCITS increased by 14.3 percent to EUR 3,362 billion.
- Net sales of UCITS reached EUR 472 billion: demand for UCITS reached its highest level ever in 2014.
- Long-term UCITS enjoyed a record year: long-term UCITS recorded net inflows of EUR 476 billion, compared to EUR 328 billion in 2013. Bond funds attracted EUR 191 billion of net inflows, closely followed by balanced funds (EUR 187 billion) and equity funds (EUR 61 billion).
- Money market funds suffered from reduced net outflows: money market funds recorded net outflows of EUR 5 billion, marking a significant decrease compared to 2013 when net outflows amounted to EUR 85 billion.
- Sales of non-UCITS reached EUR 162 billion: net sales of non-UCITS decreased slightly in 2014 from EUR 169 billion in 2013. Special funds (funds reserved to institutional investors) attracted EUR 105 billion in net new money in 2014, thanks to high institutional demand from insurance companies, pension funds and other institutional investors.



Source: EFAMA

Market overview

net sales by country of domiciliation

Nineteen countries registered net inflows in the final quarter of 2014, with ten countries recording net inflows greater than EUR 1 billion and four countries recording net inflows over EUR 5 billion.

Twenty-one countries registered net inflows in 2014, with twelve countries recording net inflows greater than EUR 1 billion and two countries recording net inflows over EUR 100 billion.

Members	Equity Funds		Bond Funds		Balanced Funds		Money Market Funds		Other Funds (2)		Total	
	Q4 2014	YTD	Q4 2014	YTD	Q4 2014	YTD	Q4 2014	YTD	Q4 2014	YTD	Q4 2014	YTD
Austria	-151	-633	830	-647	126	359	0	-27	386	1,359	1,191	409
Bulgaria	0	16	-2	8	-1	6	5	-4	0	1	3	27
Croatia	-5	-21	28	67	-3	-9	-106	-96	22	19	-64	-39 334
Czech Republic	12	79	66	133	134	324	0	-	122	429 -1	945	
Denmark	1,205	2,681	-184	2,649	184	764		20		-58 42	1,205	6,069
Finland	125	854	983	3,349	406	1,543	1	34		152	2,145	5,779
France	-5,723	-16,546	2,166	19,507	-864	5,083	589	-119	-431	-333	-19,718	-21,814 -
Germany	-4,469	-8,303	1,677	2,972	2,310	8,290	-14,866	-29,526	-101	-134	724	2,396
Greece	-36	-79	-41	-89	-7	-19	-142	-430	-5	-32	-150	-189
Hungary	2	57	148	1,097	0	121	-61	30	99	764	65	1,543
Ireland	7,984	21,056	-3,556	27,872	3,220	9,783	-184	-496 531	10,100	29,457	18,279	111,664
Italy	-299	-1,319	131	1,512	6,679	34,881	23,498	-512 -	0	0	5,999	32,705
Liechtenstein	-56	391	349	-130	3	-63	2,368		-2	-117	-23	-1,347
Luxembourg (3)	-1,129	42,169	23,930	95,150	13,729	97,179	-316	-1,427	-939	-8,926	38,979	228,006
Malta	0	-117	110	234	49	138	3,388	2,434	-6	-74 237	170	393
Netherlands	-581	-2,685	-297	-18	-69	-1,715	16	212	262	-18	-710	-4,156
Norway	-2,426	-1,682	-1,452	12,442	508	1,593 -54	0	0		26 130	-4,115	12,258
Poland	-47	-324	279	640	-247		-726	-120 525	169		832	1,551 -44
Portugal	-24	-29	-89	4	-9	15	1,314		-11	251	616	
Romania	3	15 13	83	340	3	19	89	375	126	585	218	969
Slovakia		7 0	76	277	145	402	3	10 2	0	0	236	681
Slovenia		23	7	18	7	-1		-4	-1	0	16	39
Spain	657	6,523	-592	7,622	5,971	22,034	2	0	0	0	5,966	35,609
Sweden	1,052	1,882	1,510	5,949	1,079	1,400	-70	-570 -218	761	1,705	4,184	12,643
Switzerland	-542	8,690	-242	4,982	-113	1,378	1,706		0	0	1,225	15,560
Turkey	-38	-89	69	728	144	114	2,122	510 44 -	-19	-77	200	-428
United Kingdom	1,018	8,154	-581	4,519	482	3,368	1,105 1,433	26	1,971	4,216	2,917	21,691
Total	-3,458	60,768	25,407	191,187	34,058	186,736	-9,857	-4,755	12,464	29,645	58,615	463,580

(1) In EUR millions for EFAMA members for which quarterly data are available; (2) including funds of funds, except for France, Germany and Italy for which the funds of funds data are included in the other fund categories; (3) net sales of non-UCITS are included in "other" funds, except net sales of special funds, which are shown in Table 6.

Source: EFAMA

UCITS VI

Introduction

Days after the release of the UCITS V proposal, the European Commission published a consultation document on UCITS. This publication of 26 July 2012 focused on eight topics under consideration by the EC and which may form the basis of UCITS VI.

The areas include: addressing UCITS IV, eligible assets and the use of derivatives, EPM techniques, OTC derivatives, liquidity management, depositary passport, money market funds and long term investments.

Since the consultation paper, two areas (money market funds and long-term investments) have been addressed separately outside of the UCITS framework.

In October 2014, Stephen Maijoor (ESMA's chairman) confirmed that ESMA's current focus is ensuring that the current rules are applied correctly. In his speech he mentioned that many of the pending issues have been or are in the process of being tackled via other measures. For example the issues concerning securities lending, repo and reverse repo activity have been addressed in the guidelines on ETFs and other UCITS issues published in 2012.

UCITS VI

Main discussion topics

1 Eligible Assets

- ✓ EC concern: appropriateness of sophisticated investment strategies for UCITS
- ✓ Market practice on the use of financial instruments to gain exposure to non-eligible assets
- ✓ Differentiation or limitation of scope of eligible derivatives based on pay-off of the derivative (e.g. plain vanilla vs. exotic derivatives)
- ✓ Permit only derivatives which are traded on multilateral trading platforms & cleared through CCP
- ✓ VAR vs. commitment approach: consistent indicator of global exposure relating to derivatives. Suggestion to use only leverage (commitment method) as a measure of global exposure

2 EPM

- ✓ EC concern: transparency, counterparty risk, quality of collateral, re-investment of collateral
- ✓ Assess EPM market practice and risks
- ✓ Specification of criteria for eligibility, liquidity, diversification and re-use of collateral
- ✓ Market practice regarding haircuts, merits of mandatory haircuts
- ✓ Liquidity considerations in the determination of terms or duration of EPM transactions

UCITS VI

Main discussion topics

3 OTC Derivatives

- ✓ EC concern: current UCITS framework has no requirement for calculation of OTC counterparty risk and issuer concentration (only global exposure of the UCITS is determined)
- ✓ Assessment of current framework regarding operational risks and conflict of interests
- ✓ Market practice for calculation of counterparty risk and issuer concentration
- ✓ Adequate calculation frequency, associated cost and benefits for the involved stakeholders
- ✓ Consistency of collateral requirements for non-cleared OTC derivatives and EPM techniques

4 Liquidity bottlenecks

- ✓ EC concern: liquidity bottlenecks during the financial crisis, investors were unable to redeem
- ✓ Definition of exceptional cases (quantitative and/or qualitative criteria)
- ✓ Temporary suspension of redemptions – should time limits be introduced?
- ✓ Market practice on the use of side pockets
- ✓ Need for liquidity safeguards in ETF secondary markets

UCITS VI

Main discussion topics

5 Depositary Passport

- ✓ AIFMD and UCITS V will harmonise EU depositary rules and therefore possibly create the basis for an EU depositary passport
- ✓ Advantages and drawbacks for the creation of EU passport for depositaries
- ✓ Would the introduction of a depositary passport require further harmonization (NAV calculation, tasks, permitted activities, capital requirements, supervision, etc.)
- ✓ Specific issues, burdens, costs which are associated with the supervision if the UCITS and depositary are not located in the same country

6 Money Market Fund

- ✓ EC concern: systemic risk associated with Money Market Funds (MMFs), widely used by all types of investors; perception as “safe” investment
- ✓ Valuation and capital: additional regulation for Constant NAV (CNAV) funds or even phase out
- ✓ Liquidity and redemptions: MMFs ability to deal with large redemption requests in case of liquidity constraints. Solicits opinion on different measures, e.g. liquidity fees, redemption restrictions and liquidity constraints.
- ✓ Investment Criteria and Rating: MMFs reliance on credit ratings to assess credit risks of assets. Commission asks would banning ratings reduce the potential for systemic overreactions to a sudden downgrade.

UCITS VI

Main discussion topics

7 Long-term Investments

- ✓ EC concern: funds with long-term investments generally have a low level of liquidity, are associated with lock-up periods and are therefore reserved for institutional investors
- ✓ Review of options available to retail investors to make long-term investments
- ✓ Promote investment in unlisted companies (early or mature stage), infrastructure projects, 'real' assets (real estate, other physical assets), and third-party managed funds making investments in unlisted companies
- ✓ Creation of a common framework, eligible assets, diversification rules, use of leverage, etc.

8 UCITS IV

- ✓ Self managed investment companies – empower Commission under Level 1 to adopt delegated acts
- ✓ Master-feeder structures: scenario “feeder UCITS converts into ordinary UCITS“ – information standards
- ✓ Improvement of notification procedure between member states
- ✓ Notification for cross-border mergers: 20 working days – increase legal certainty
- ✓ Alignment with AIFMD. Some of AIFMD’s provisions are more detailed: organisational rules, delegation, risk and liquidity management, valuation, reporting or calculation of leverage

UCITS V

UCITS V

2012	UCITS V proposal Published
15 April 2014	Adoption by the European Parliament
23 July 2014	Adoption by the Council of the EU
28 Aug 2014	Published in the Official Journal
17 Sept 2014	Directive entered into force
24 Oct 2014	ESMA Consultation on depositary delegated acts closes
End Nov 2014	Submission of technical advice on delegated acts to the EU Commission
18 Mar 2014	Remuneration Guidelines, ESMA implementing technical standards on penalties and Commission delegated acts on depositaries expected
18 Mar 2016	Deadline for transposing UCITS V into national law
18 Mar 2018	Deadline for appointing a depositary which complies with UCITS V eligibility requirements

UCITS V

Focus on investor protection

Draft paper	Commission proposal	Parliament & Council	Political agreement	Adopted	**Technical measures**	Implemented

Jul 2012	Apr 2014	17 Sept 2014	2014/2015	18 Mar 2016	18 Mar 2018
Commission proposal	Adopted	Directive enters into force	Technical advice and remuneration guidelines	Deadline for transposing into national law	Eligible deadline

The financial crisis highlighted divergent depositary regimes across the EU and focussed regulators on remuneration and behaviour in the financial sector.

UCITS V aims to harmonise 3 areas:

- UCITS depositary regime clarifying duties and liability
- Remuneration rules with other sectors
- Sanctions regime for UCITS breaches

UCITS V was approved by the European Parliament on 15 April 2014 and by the EU Council on 23 July 2014.

It must be transposed by member states by 18 March 2016, and existing depositaries have until 18 March 2018 to become eligible under UCITS V.

Key features

- ESMA will issue remuneration guidelines to specify applicability to delegates and to employees subject to different sets of remuneration requirements (AIFMD, CRD, MiFID)
- The total variable remuneration shall generally be considerably contracted in subdued or negative financial performance
- Remuneration paid to management companies is also subject to the remuneration principles
- At least 40% of variable remuneration should be deferred (EP had proposed 25%) over a period of at least 3 years
- Custody assets may only be reused (e.g. for securities lending) subject to new requirements, including title transfer of high quality, liquid collateral to the UCITS under the arrangement
- Limit of depositary eligibility entities that meet minimum conditions

Key elements

Depositary

- The depositary framework is aligned with AIFMD, clarifying new safekeeping (including strict liability), oversight and cash monitoring duties.
- Unlike AIFMD, the depositary will not be permitted to contractually discharge liability.

Remuneration

- The rules on remuneration also reflect those of AIFMD.
- The rules include the establishment of a remuneration policy to promote sound and effective risk management.
- Rules on payment of 50% of bonus out of units of the fund, bonus deferral over at least 3 years and clawback and malus provisions apply.

Sanctions

- UCITS V proposes a minimum catalogue of administrative sanctions and a minimum list of sanctioning criteria.
- Public reprimands are a feature of the proposed regime.

ESMA’ consultation on different share classes

ESMA's consultation on different share classes of UCITS

What is a share class?

- Categories of shares within the same UCITS which allow subsets of investors to achieve "some level of customisation which accommodates their specific needs

Published 23 December 2014

- What is a share class?
- 3 principles regarding legality
- 14 questions for stakeholders

Closes 27 March 2015.

Principles to use in addressing the legality of share classes

- Same investment strategy.
- Features specific to one share class should not have a potential (or actual) adverse impact on other share classes.
- Disclose differences between share classes to investors when there is a choice between two or more classes.

Depositaries – independence and insolvency protection

UCITS V

depositaries: independence and insolvency protection

Independence requirement

- Cross management & supervision
- Cross share-holdings

28 November 2014 ESMA published technical advice to the European Commission on delegated acts required by the UCITS V Directive on the content of two of the delegated acts on depositaries.

Insolvency protection of assets when delegating safekeeping

- Steps to be taken by the delegate third party
- Measures the delegating depositary must adopt

ESMA’s guidelines on ETFs and other UCITS issues

ESMA's guidelines on ETFs & 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

ETFs Index tracking

Collateral criteria for OTCs and EPM

EPM techniques

Total Return Swaps

Financial indices

PRIIPS – KID - KIID

Packaged Retail and Insurance-based Investment Products - PRIIPS

Packaged Retail and Insurance-based Investment Products (PRIIPs) is an initiative aimed at better protecting and informing consumers in relation to products they may be offered.

The PRIIPs Regulation requires the production Key Information Documents (KID) by PRIPs manufacturers and sellers. The 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 5 years.

The PRIPS KID regulation came into force on 29 December 2014, it applies in all Member States from 31 December 2016, and becomes applicable to UCITS in 2019 at the earliest.

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

The KID

- Applicable to manufacturers of PRIIPs and to persons advising or selling PRIIPs in banking, insurance, securities and funds sectors (some exemptions apply)
- Written in the official language(s) of the member state or another language accepted by the regulator of that member state
- Should be easy to understand and regularly updated
- The KID is to be provided in good time before any transaction is concluded
- The KID may be provided in electronic means but the investor should be given the option to receive it on paper free of charge
- The PRIIP manufacturer will be held liable for any misleading, inaccurate or inconsistent information within the KID and a retail investor should be able to claim damages for a loss resulting from reliance on a KID
- The retail investor should be able to hold the PRIP manufacturer liable for an infringement in case a loss is caused though the use of the KID
- The content and review process of the KID will be developed under regulatory technical standards to be drafted by the European supervisory authorities (ESMA, EBA, EIOPA)
- Regulators will have new product intervention powers under MiFID/PRIIPs and also sanctioning powers in relation to the KID
- The European Supervisory Authorities (ESAs) have monitoring and intervention powers under MiFID and PRIPs to temporarily prohibit or restrict the marketing, sale or distribution of a product where concerns for investors arise
- National regulators must lay down administrative sanctions for breaches of the PRIPs rules, which include public reprimands and fines

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

Packaged Retail and Insurance-based Investment Products - KID v KIID

KID (across all retail products)

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

Headings:

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

Headings:

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

Q&A