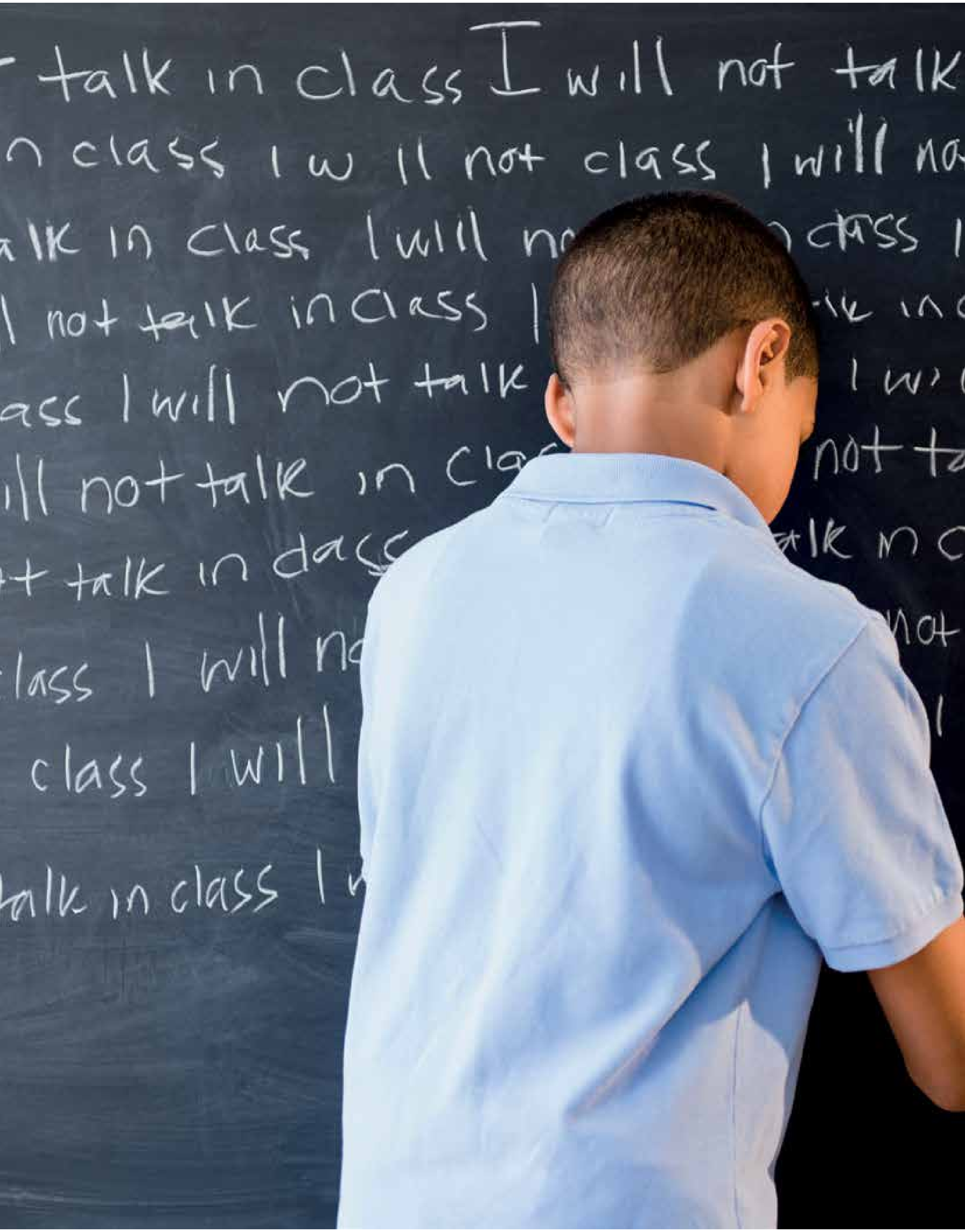
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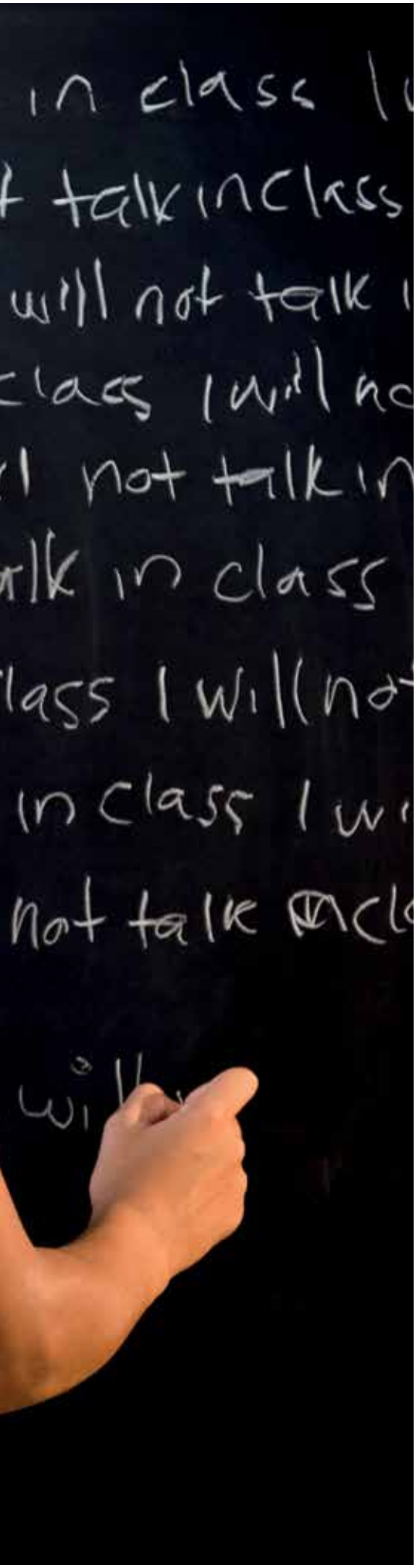

Preparation for UCITS V sanction rules

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Introduction

The current criminal and administrative sanction landscape in Europe is a patchwork of differing sanction regimes that vary country by country: each country defines when a sanction is imposed and the severity of that sanction. Most importantly, there is no obligation at present to publish the results of findings, leaving consumers unable to verify if an investment fund entity with which they are looking to enter into a business relationship is compliant with the relevant regulatory frameworks. This is about to change.

Having recognised this lack of harmonised approach, the European Commission has drafted a regulatory response under UCITS V to tackle the issues.

What does the UCITS V sanction regime aim to address?

The main aim of the sanction regime under UCITS V, which was adopted into European law on 28 August 2014, is to determine the rules for a consistent approach to the application of administrative sanctions and to ensure that each member state implements the rules into national law with a minimum level of consistency. UCITS V determines the levels of sanction measures for non-compliance or repeated breaches and provides clarification on the parties responsible for compliance.

The overall intention of the regulation is that the end result will be a regulatory framework for the registration and reporting of infringements, consistently applied across Europe.

One of the key points of the regulation is that each member state will be required to ensure a competent authority publishes any decisions on sanctions. This 'naming and shaming' should go some way to ensuring that investors have access to the same information. It will also be interesting to see how each member state transposes UCITS V into national law, especially with regard to the definition of 'repeated' in relation to breaches.

Key areas of the sanction regime—article 99 (amending Directive 2009/65/EC)

The replacement of article 99 covers six main areas: authorisation to conduct business, operating conditions, risk management, notification requirements, publication of sanctions and whistleblowing. Each member state will be required to reduce administrative sanctions into national law by February 2016, where a criminal sanction does not already exist. Under this regime, there is a focus on the requirement to publish findings and a strengthening of the requirements for companies to implement procedures for whistleblowing.

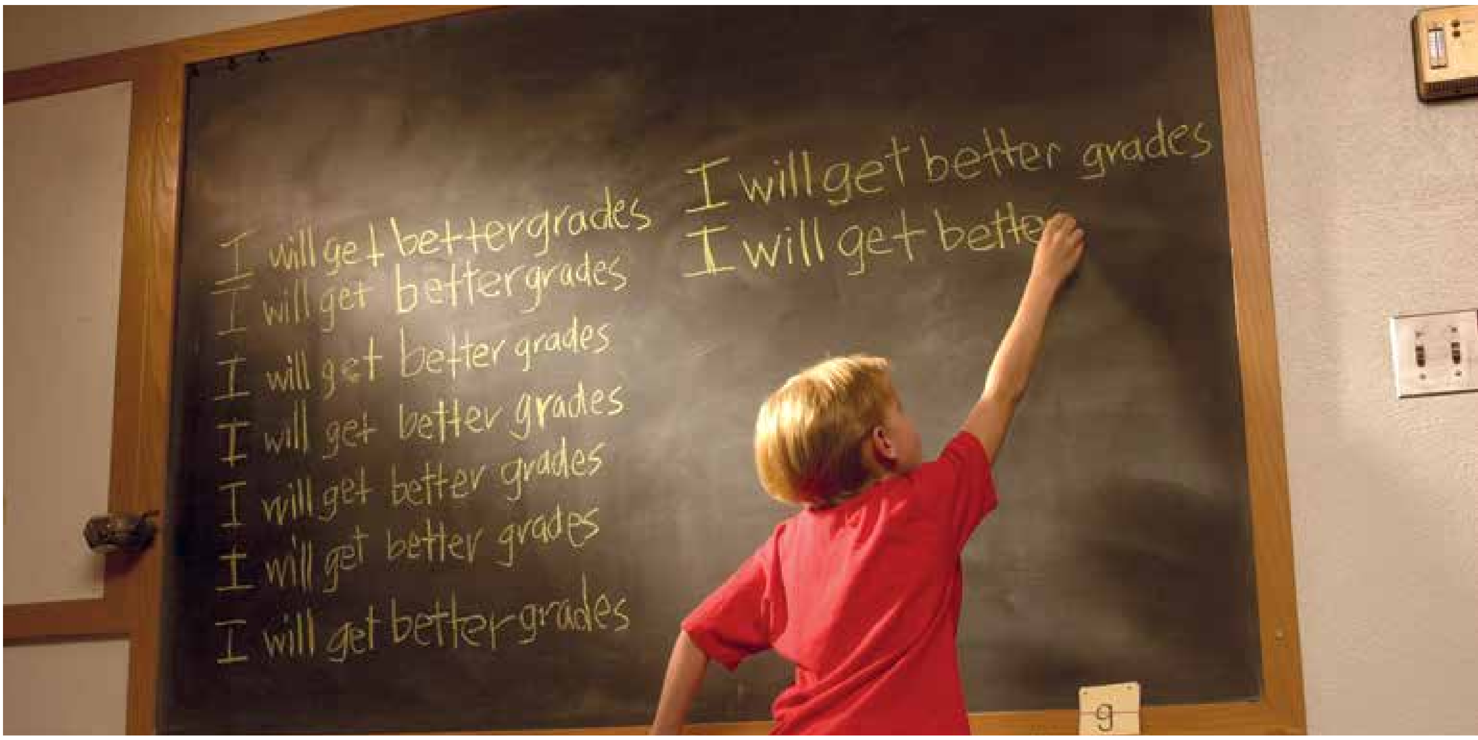
Category	Application of sanction
Authorisation to conduct business	• Failure to obtain proper authorisation prior to conducting UCITS activity • Non-compliance with obligations for annual reporting of qualifying holdings
Operating conditions	• Absence of sound administrative and accounting procedures, control and safeguarding of electronic data and internal control measures • Absence of personal transaction rules • Non-compliance regarding delegated functions • Rules of conduct failure • Depositary regime failure
Risk management	• Absence of sound risk management processes. Focus on independent assessment of value of OTC derivatives • UCITS investment policy failure
Notification requirements	• Failure concerning obligatory investor information • Failure of UCITS notification requirements
Publication	• Public statement of responsible persons and details of failure
Whistleblowing	• Failure to establish measurement and reporting procedures • Failure to implement procedures for employees to report failures • Failure to provide protection of employees

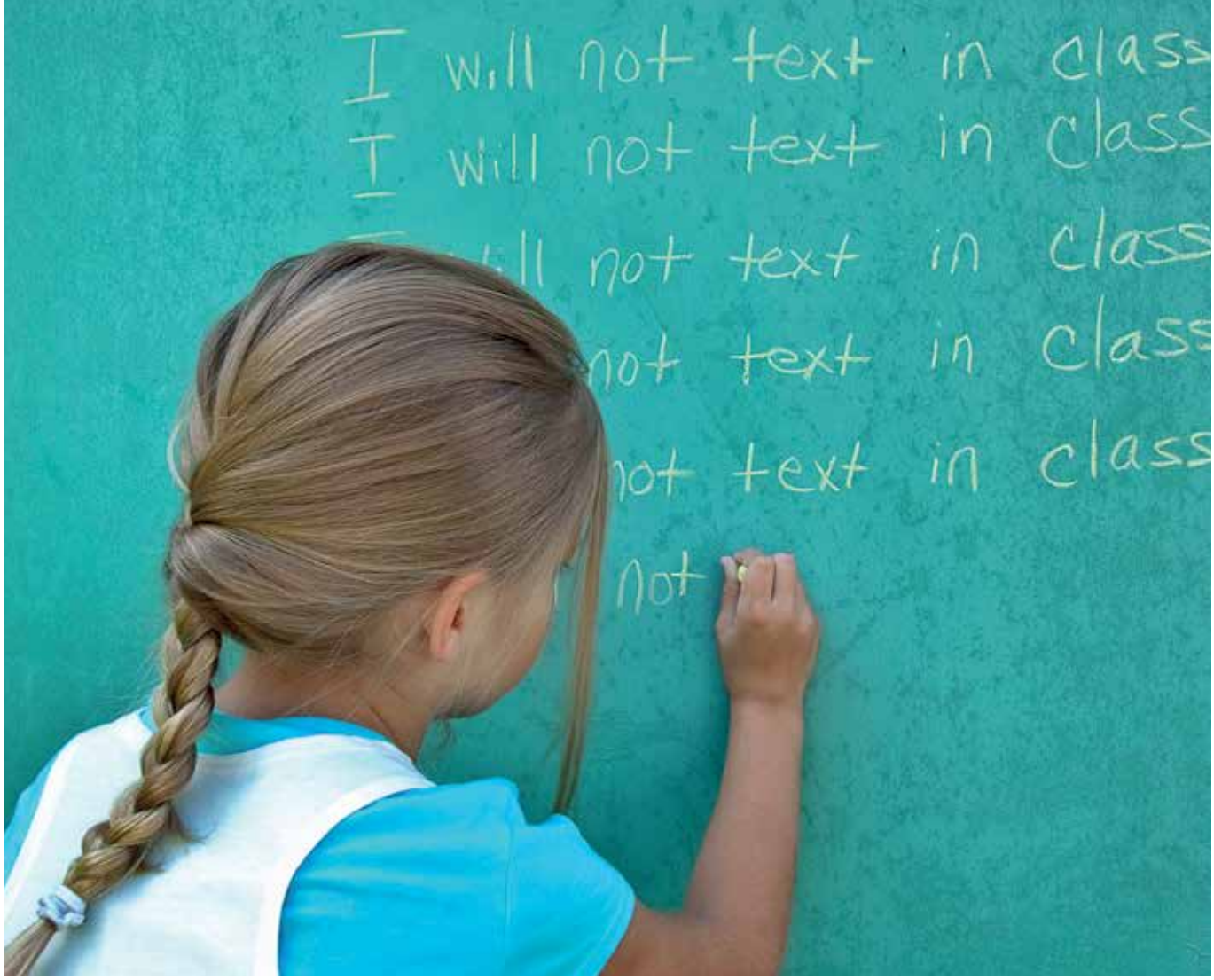
Sanction penalties

The regulation provides that, in the event of an infringement, management companies, investment companies and depositaries may be subject to the following administrative penalties:

- In the case of a UCITS or a management company, suspension or withdrawal of its authorisation. This may take the form of a temporary suspension or for repeated infringements, a permanent ban against a member of the management body or any other natural person who is held responsible exercising management functions in those or in other such companies
- The person responsible will be issued with an order to cease the conduct and desist from a repetition of that conduct in the initial phase
- In the case of a responsible person, the maximum fine under the administrative sanction regime will be €5 million (or equivalent in another currency) for natural persons and €5 million or 10% of annual revenue for legal entities

One of the key points of the regulation is that each member state will be required to ensure a competent authority publishes any decisions into the public domain





What is the impact on the the industry?

Aside from the requirement to have obtained the necessary authorisations, asset managers and investment companies will be required to ensure they have the right organisational and governance structure in place to comply with these regulations and previous versions. This not only applies to their own organisation but it also means that they will have to monitor any activities they have delegated to ensure that they are being administered appropriately.

An example of this is ensuring that depositaries provide regular reporting on the services they provide to the management company through adequate supervision and the establishment of risk committees. In particular, process failures must be recorded. Since the regulations do not contain an explicit explanation of 'frequent errors', it will be interesting to see how each member state defines this—hopefully with a consistent approach in terms of definition and application.

The parties responsible for delegated functions should be aware of the requirement for greater due diligence on behalf of asset managers, as well as the need for effective reporting detailing the performance of obligations, and more importantly, the nature and frequency of failures.

Given that the regulations provide for fines to be imposed on natural persons or legal entities, it may be appropriate to consider ensuring that adequate insurance cover is in place, protecting those persons that may be held responsible for non-compliance. These persons should ensure they have obtained the appropriate authorisations to act in the capacity of a responsible person. The new regulations may lead to a modification or expansion of the responsibilities of Chief Operating Officer (COOs)/conducting officers. In addition, consideration could be given to rotating the COO/conducting officer role on a more frequent basis. This can have the added benefit of reducing risk and allowing for a greater understanding of the obligations of responsible persons across the management team.

Of course, an insurance policy cannot protect against the reputational damage a sanction represents. As the publication requirements stipulate that both companies and natural persons are identified, organisations need to ensure that whistleblowing procedures are implemented appropriately. The risk of reputational danger greatly increases the need to ensure full compliance.

What are the next steps?

The industry awaits the definition and clarification of the classification of 'repeated failures', as interpreted by member states, as this is likely to be the most common area of concern. It is to be hoped that this is viewed pragmatically, thereby negating the need for extensive reporting. What is key in this regard is the implementation of clear procedures for employees to report events, and for appropriate escalation. The reputational risk of 'in good faith' or 'in bad faith' reporting of failures can have a negative impact. With regard to reporting, ESMA has been requested to provide further guidance on the procedures and forms for submitting information.

While there is a common view that most of the measures mentioned in the regulations are not new, it is prudent for asset managers, investment companies and depositaries to get started on the process of reviewing their organisations to ensure that they have the appropriate corporate and governance structure in place and reassure themselves that delegated functions are administered in accordance with expectations. It will also be essential to ensure that employees and other persons involved in the activity of UCITS are aware of their obligations, especially in the area of whistleblowing and personal transactions. The consequence of a rigidly enforced regime could, in the event of a failure to fulfill obligations, result in significant penalties being imposed on both organisations and responsible persons.

Member states are required to transpose UCITS V into national law by February 2016.

To the **point**:

- The current European landscape of administrative sanctions is disharmonised and inconsistently applied
- UCITS V aims to address this with the outlining of a common approach to be implemented into national law
- The UICTS V sanction regime will be required to be implemented into national law by February 2016
- Investment companies, management companies and depositaries should start to anticipate these requirements
- In the midst of regulation after regulation, this important regime may be overlooked
- Service providers should also be aware of the requirements, in order to be compliant towards their clients
- Breaches of the regime will result in pecuniary measures against both the company and responsible persons
- The regime foresees a publication of pecuniary damages into the public domain
- In addition, guidelines for employer/ employee whistleblowing procedures are outlined