

MEMO# 27969

March 24, 2014

Agreement Reached on UCITS V - Remuneration Policies and Practices

[27969]

March 24, 2014

TO: ICI GLOBAL REGULATED FUNDS COMMITTEE No. 2-14
ICI GLOBAL STEERING COMMITTEE No. 4-14
INTERNATIONAL COMMITTEE No. 7-14 RE: AGREEMENT REACHED ON UCITS V -
REMUNERATION POLICIES AND PRACTICES

On 19 March, the Permanent Representatives Committee, on behalf of the Council of the European Union (Council), reached an agreement with the European Parliament (EP) on a proposal to amend directive 2009/65/EC on undertakings for collective investment in transferable securities (UCITS V). The UCITS V directive focuses on three main areas: (i) clarification of the UCITS depositary's functions and liability in circumstances where assets are lost in custody, (ii) rules governing remuneration policies which UCITS will be obliged to introduce (substantially the same as in the Alternative Investment Fund Managers Directive) and (iii) the harmonisation of the minimum administrative sanctions regime across Member States. The agreement now allows the amending directive to be adopted at first reading before the EP adjourns for elections at the end of May.

We have been particularly focused on and concerned with the provisions regarding remuneration. These provisions may have a significant impact on how certain categories of staff of a fund manager are compensated and may particularly impact firms that have adopted consistent firm-wide compensation practices or those that provide portfolio management services to EU based firms. The remuneration provisions are substantially similar to those included in the Alternative Investment Fund Managers Directive (AIFMD) and the AIFMD remuneration guidelines issued by ESMA; there are, however, certain noteworthy differences.

Under the agreed text, Member States will have 18 months to transpose the directive into national law, and depositaries will be given an additional 24-month transition period after the transposition deadline.

The remuneration requirements are described briefly below.

Requirement to Establish Remuneration Policies and Practices

New Article 14a provides that Member States shall require management companies to

establish and apply remuneration policies and practices that are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS they manage and do not impair compliance with the management company's duty to act in the best interest of the UCITS. These policies are required to include fixed and variable components of salaries and discretionary pensions.

Covered Staff

Article 14a provides that the remuneration policies and practices shall apply to those categories of staff, including senior management, risk takers, control functions and any employees receiving total remuneration that falls within the remuneration bracket of senior management and risk takers whose professional activities have a material impact on the risk profiles of management companies or of the UCITS they manage. Notably, Recital 2 expands upon this and states that those 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, senior management and any employees receiving total remuneration that takes then into the same remuneration bracket as senior management and decision takers."

Application to Third Parties

A matter of significant concern, and a source of contention between the Council and EP, was the potential inclusion of provisions in the amended directive regarding the application of the remuneration provisions to third parties. In the context of the AIFMD, a provision regarding the application of the principles to third parties was included only in the remuneration guidelines issued by ESMA. Application to third parties was not addressed in Level 1 or Level 2. We, together with other European fund industry associations, lobbied relevant European policymakers arguing that such a provision should similarly not be included in UCITS V. Sven Giegold, the UCITS V rapporteur who earlier in the UCITS V process was unsuccessful in his attempt to include a bonus cap, however, was determined to have such a provision included in the UCITS directive.

Ultimately, it was agreed that the following language be included in Recital 2 (but not in Article 14a): "These policies and practices should apply, in a proportionate manner, to any third party which takes investment decisions that affect the risk profile of the UCITS because of functions which have been delegated in accordance with Article 13." Although we preferred that this delegation provision not be included in the UCITS V text at all (as was the case with the AIFMD), this new language does include a proportionality provision which, when applied, could result in at least some non-EU investment advisers not having to comply with these requirements with respect to their staff.

ESMA Guidelines

Article 14a provides that ESMA shall issue guidelines addressed to competent authorities and/or financial market participants concerning covered staff and the application of the principles. The directive further provides that ESMA shall cooperate with the EBA in order to ensure consistency with requirements developed for other sectors of financial services, in particular credit institutions and investment firms.

Remuneration Principles

The directive lists a number of principles with which management companies will be

required to comply with respect to the establishment of their remuneration policies. These principles are substantially the same as those applicable to AIFM. It also provides that a management company may comply with the principles in a way and to the extent that is appropriate to the company's size, internal organization and the nature, scope, and complexity of the company's activities.

Among the principles are the following:

- The remuneration policy must include measures to avoid conflicts of interest.
- The management body must annually review the remuneration policy and is responsible for and oversees its implementation.
- The implementation of the remuneration policy must be subject to central and independent review at least annually.
- Guaranteed bonuses should be "exceptional" and may only occur in the context of hiring new staff for the first year of service.
- The fixed and variable components of total remuneration should be appropriately balanced. The fixed component should represent a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component at all.
- Subject to the legal structure of the UCITS and its fund rules or instruments of incorporation, at least 50% of any variable remuneration must consist of units of the UCITS concerned, or equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments with equally effective incentives as any of the above, which will be subject to an appropriate retention policy designed to align incentives with the interests of the management company, the UCITS it manages and the investors in such UCITS.
- At least 40% of variable remuneration should be deferred over a period which is appropriate in view of the holding period recommended to the investors of the UCITS concerned. The period shall be at least three years. Where the variable remuneration component is particularly high, at least 60% of the amount should be deferred.

Remuneration Committee

As in the AIFMD, the directive provides that management companies that are significant in terms of their size or the size of the UCITS they manage, their internal organization and the nature, the scope and the complexity of their activities shall establish a remuneration committee that shall be constituted in a way that enables it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk.

Eva M. Mykolenko
Associate Counsel - International Affairs