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UCITS V Gets EU Political Backing, Foreshadowing New Limitations on Manager Remuneration

European lawmakers have reached agreement on amendments to the Undertakings for the Collective Investment in Transferable Securities (UCITS) Directive, which regulates the management and marketing of EU mutual funds. These changes are commonly known as UCITS V and, once adopted, will be phased in over the next 18 months to two years.

UCITS V contains new provisions on UCITS depositaries' duties and liabilities and requires sanctions to be imposed for UCITS compliance breaches. However, the main area of market focus is the new remuneration requirements.

In recent years, the EU has imposed remuneration obligations on alternative investment fund managers through the Alternative Investment Fund Managers Directive (AIFMD) and on discretionary investment advisers, banks and broker-dealers through the Capital Requirements Directives.

UCITS V seeks to impose similar remuneration obligations on UCITS managers, although an initial proposal to impose a banker bonus-style cap was dropped last year. UCITS managers will need to make material changes to their remuneration structures and policies to comply with the following requirements:

- "identified staff" must receive at least half of their variable remuneration in assets of the UCITS they manage (or in "equivalent investments" such as units that are linked to the value of those UCITS);
- at least 40 percent of variable remuneration paid to identified staff must be deferred for at least three years; and
- the UCITS' annual report must disclose details of the remuneration paid by the UCITS manager, including a breakdown between fixed and variable remuneration and between senior management and other employees who have a material impact on the UCITS' risk profile.

One key question is the impact of these changes on delegates of the UCITS management company. Many UCITS funds are structured so that investment management is delegated to investment advisers and occasionally sub-advisers based in a wide variety of EU and non-EU jurisdictions.

As part of AIFMD implementation, the European Securities and Markets Authority (ESMA), when producing guidelines on alternative managers' remuneration policies, made clear that alternative managers should ensure that portfolio or risk management delegates are subject to equivalent remuneration rules.

In the context of UCITS V, many commentators have taken the view that a similar approach will either be taken in the final legislation itself, or, more likely, in further ESMA guidelines, thus bringing a number of non-EU UCITS investment advisers within scope

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of the new UCITS remuneration rules. If correct, this would produce a number of compliance difficulties and potential tax consequences.

- The payment of UCITS units to an employee of a U.S. investment adviser is potentially an offer of securities in the U.S., which would trigger registration requirements. Although it is possible that the payment could merely be a private placement, it could have the unattractive result of the UCITS being deemed a foreign private issuer or being forced to rely on Section 3c1 or 3c7 exemptions as well as other additional U.S. reporting requirements.

- From a U.S. and U.K. tax perspective there are some difficult issues arising from an award of unvested UCITS units. In the U.K., tax may be immediately chargeable on remuneration, which identified staff working within a partnership cannot access as a result of the deferral requirements. Unfortunately, a new concessionary U.K. tax regime that can mitigate the impact of upfront tax charges prior to vesting is not currently drafted so as to apply to UCITS management entities or their discretionary investment advisers unless the bulk of their business is from managing alternative investment funds.

However, there is an admittedly more optimistic view that suggests ESMA may take a different approach and not apply UCITS remuneration rules to third-party delegates, such as discretionary investment advisers. Even if that hope proves unfounded ESMA guidelines are likely to contain a proportionality principle, which when applied could result in at least some non-EU investment advisers not having to comply with these requirements when paying their staff.