The New UCITS IV Directive: Risks and Opportunities

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The publication of the prospective Alternative Investment Fund Managers (“AIFM”) Directive\(^1\) has led a number of commentators to say that the European regulatory establishment is leading a lynch mob against the private fund industry. The argument goes that, as is often the case with lynch mobs, there may be an intention on the part of those leading the mob to divert attention away from their own inadequacies and failings. The advantages and shortcomings, as well as the details, of the prospective AIFM Directive have been well covered by commentators\(^2\). This article, however, seeks to address a more happily received directive, namely the UCITS IV Directive\(^3\) (“UCITS IV Directive”), with a view to assessing how the private fund industry can best interact with this standard bearer for European public funds.

UCITS Over Time

The UCITS IV Directive (adopted by a vote of the European Council on 22 June 2009, following approval by the European Parliament in January 2009) is the fourth European Directive covering Undertakings for Collective Investment in Transferable Securities (“UCITS”). The first UCITS European Directive\(^4\) was introduced in 1985, and was later amended by two directives (collectively, “UCITS III” and consisting of two directives: the Management Directive (Directive 2001/107/EC) and the Product Directive (2001/108/EC))\(^5\). The aim was to establish a single regulatory regime across the European Union for open-ended investment funds to invest in transferable securities (such as shares, bonds, etc.) to create wider investment and business opportunities for investors and asset managers and to define high levels of investor protection.

The UCITS project allows investment funds that fulfil the requirements of the UCITS Directive (in theory at least) to be freely marketed, under the European passport, throughout the European Union.

The UCITS project has been a success, so much so that the UCITS brand is now recognised as a globally distributed investment fund product enjoying considerable pan-European and worldwide success, particularly in Asia, Latin America and the Middle East. However, various inefficiencies have been identified and the resulting proposals contained in the UCITS IV Directive are set to strengthen the brand. As set out below, the UCITS IV Directive will also potentially offer certain non-EU fund managers the opportunity to access the European markets without being brought into the prospective AIFM Directive\(^6\). The five key changes built into the UCITS IV Directive are set out below.
The UCITS Framework: Why UCITS Has Been So Successful

**Risk Diversification:** A key principle of the UCITS legislation was (and remains) risk diversification, such that (with exceptions for, e.g., deposits with EU banks) no investment can exceed 10% of the relevant UCITS fund’s net asset value, with further restrictions such that any fund would be required to have not less than 16 separate investment holdings (the so-called “5-10-40 rule”). This prevented master-feeder arrangements (until UCITS IV – see below).

**Eligible Assets:** Although the UCITS directive’s key target investment criteria is built into its title (transferable securities), UCITS III had substantively widened the eligibility criteria to include money market instruments, fund units, bank deposits and derivatives – it being "desirable that UCITS [funds] should be permitted . . . to invest in financial instruments, other than transferable securities, which are sufficiently liquid". There was a significant amount of controversy over where exactly the limits of the newly eligible classes were; and, in March 2007, the Committee of European Securities Regulators ("CESR") put out guidelines as to what assets could be considered eligible for UCITS. These guidelines were aimed at restricting techniques, typically using derivatives, that had been developed by some UCITS fund sponsors/managers to circumvent the spirit of the eligibility criteria and have generally been effective in laying down more detail on what specific regulators should permit.

**Leverage:** UCITS III allowed UCITS funds to borrow up to 10% of its net asset value on a temporary basis. While this suggested that any significant kind of long-term leverage would therefore be ineligible, the broadening of the eligibility criteria to allow for investment in derivatives necessarily allowed synthetic leverage. The restrictions on the global exposure of a UCITS fund to derivatives had been limited to the net asset value of the fund, with further restrictions on single counterparties and permitted underlying assets (as above). In addition, the regulators were enjoined to ensure that “appropriate risk management controls” are in place in order to invest in derivatives (this being interpreted to allow sophisticated fund managers with “VAR” (or “value-at-risk”) controls to operate on a net basis). In addition, because the use of repo financing was not deemed by certain key regulators to be “borrowing”, repo financing is generally not caught by the restrictions on borrowing (which has typically been interpreted very narrowly to mean loan and overdraft financing – although note the effect of the 15 June 2009 CESR consultation paper, which proposes that repo exposures be brought into the global exposure calculations).

**Liquidity:** The UCITS framework requires that the units of any particular UCITS fund must be redeemable not less than twice a month (subject to a right granted to regulators to reduce that obligation to monthly if no prejudice is determined likely for particular investors and to a right to suspend and “gate” redemptions in particular circumstances). Another key feature to the UCITS liquidity provisions requires that investors be allowed to redeem on short notice. This principle has been tested recently by the serious impairment to various asset classes, such as credit and particularly asset-backed securities, following on from the credit crisis and particularly the Lehman bankruptcy and related banking crises. It should be noted however that UCITS recognises reality and, although subject to regulatory oversight, allows “gating” and suspensions.

The factors described above, together with generally rigorous oversight by the key regulators of internationally targeted UCITS funds (primarily Luxembourg and Ireland), has made the brand strong. Resulting key advantages of maintaining/marketing a UCITS fund include:
Selling the product into the EU and “UCITS-recognizing jurisdictions”: once approved by the home jurisdiction regulator, in theory the promoter was (subject only to minor procedural obligations) allowed to market an approved UCITS fund across the European Union; and

Reputational backing: as most recently evidenced by the European regulatory reaction to the Madoff scandal, European regulators take their role as guardians of the UCITS brand seriously. Additionally, the fact that the UCITS framework requires the managers to be appropriately qualified, to establish independent valuations and maintain an independent depositary means that UCITS funds can wear their “regulated” badge with some pride.

**Major Proposed Legislative Changes in the UCITS IV Directive**

The UCITS IV Directive does not seek to tamper with the basic principles of the UCITS III advances, so that (other than as set out in the new master-feeder arrangements) the investment diversification principles of UCITS III remain substantially unaffected. The principal changes in UCITS IV are as set out below:

**Master-Feeder Funds – Subject to approval from the regulator and from investors, a UCITS feeder fund will be allowed to fully invest its assets into another UCITS (master fund):**

- Perhaps the most crucial proposal of the UCITS IV Directive for opening up the European markets to U.S. fund operators is to enable cross-border Master-Feeder structures – such structures were specifically excluded under UCITS III: for example, previously if a fund manager had an established UCITS in Luxembourg and wanted to offer this UCITS in the United Kingdom, the fund manager would have to go through the notification procedure and comply with the FSA rules and regulations. In this same scenario, under the UCITS IV proposals a Feeder UCITS wishing to invest in an offshore Master UCITS could be established in the United Kingdom with relative administrative ease and reduced cost and, provided the Feeder UCITS is UCITS compliant (the key requirements are set out below), the United Kingdom should not impose any additional regulations. The new Master-Feeder structure also solves the marketing problem where investors want to see an on-shore vehicle with local currency offerings. The key provisions of the UCITS IV Directive regarding the master-feeder structure are:
  - The Feeder must have been approved (by its home Member State) to invest a minimum of 85 per cent. of its assets into a Master UCITS;
  - The sole permitted investments of the Feeder UCITS consist of 85 per cent. of the Master UCITS and the remaining 15 per cent. in investments prescribed by the UCITS IV Directive, including ancillary liquid assets and financial derivative instruments – the Feeder UCITS is not subject to the diversification requirements;
  - Only the initial investment by the Feeder UCITS into the Master UCITS requires approval from the Feeder UCITS’ competent authority;
  - Existing UCITS may convert into Feeder UCITS, provided the requirements of the UCITS Directive (including production of a statement that the competent authorities of the feeder UCITS’ home Member State approved the investment of the Feeder UCITS in units of such...
Master UCITS and the date when the Feeder UCITS is to start to invest in the Master UCITS) are complied with;

– Other requirements include that the Master UCITS must (a) have at least two investors, (b) not be a Feeder UCITS itself, (c) not hold units of a Feeder UCITS, and (d) there must be a legally binding agreement between the Feeder UCITS and the Master UCITS regulating the relationship between the two (if both the Feeder UCITS and Master UCITS are managed by the same investment management company, the requirement for a legally binding agreement between Feeder and Master UCITS may be replaced by internal conduct of business rules).

One feature of the liberalised Master-Feeder arrangements that remains sacrosanct is the requirement that the Master UCITS be a UCITS authorised under the UCITS Directive (i.e. established in an EU state).

**Notification procedure when marketing across Member States – there will be a new regulator-to-regulator notification procedure for cross-border marketing of UCITS in the EU:**

Eurocratic legalease has described the proposed changes to the notification procedure (the process whereby a UCITS authorised and supervised in one Member State obtains authorisation to market its units in another Member State) as the “radical simplification of the cross border notification procedure”\(^\text{10}\): At present the notification procedure can be lengthy and expensive, with the time lag between the initial notification and the start of marketing creating a serious disadvantage. Certain Member States, including for example Italy and France, require additional documentation, further regulation and hurdles (including extensive translations of documents) to be overcome before marketing can start. The key changes under the UCITS IV Directive are:

- Removal of two-month waiting period – UCITS can commence marketing once the notification has been made by the UCITS home Member State to the UCITS host Member State;

- UCITS may access the market of the UCITS host Member State as of the date of the notification and the competent authority of the host Member State will not be entitled to review, challenge or discuss the merits of the UCITS. The UCITS IV Directive includes a restriction on any additional requirements or administrative procedures by the host Member State on the UCITS authorisation granted in the home Member State;

- UCITS home Member State regulator now only has 10 working days to review the notification file and to transmit it to the host Member State;

- Host Member State can impose local marketing rules on the UCITS but only after notification and marketing has commenced;

- Reduction in the number of documents to be filed with the competent authority – under the proposals, the sole documents to be filed with the competent authority of the host Member State prior to the start of marketing are: the new notification letter; an attestation that UCITS fulfils the requirements of the UCITS Directive, the fund rules or incorporation documents; the prospectus; (where appropriate) the latest annual and semi-annual reports; and the Key Investor Information document (see below for further detail); and
Only the Key Investor Information document has to be translated into the official or authorised language of the host EU Member State.

**Management company passport – the proposed introduction of a passport for management companies will allow a UCITS to be managed by a management company authorised and supervised in a member state other than its home member state:**

Potentially the most controversial of the UCITS IV Directive’s proposals will allow a UCITS to be managed by a management company authorised and supervised in a Member State other than its home Member State. Under UCITS III a management company, if appointed, has to be domiciled in the same country as the UCITS, but the UCITS IV Directive proposals will enable remote fund administration by the management company so that asset managers can sell funds across the EU without having to establish a full suite of administrative functions for every jurisdiction. The passporting regime will not be available in a non-EU jurisdiction and a UCITS must therefore be registered under the local regime and comply with all local registration and compliance requirements. Also required is approval of the choice of the management company by the regulator of the UCITS. The aim of the management company passport is to achieve economies of scale, enhance freedom of establishment and reduce costs, but some Member States (such as Ireland and Luxembourg) have argued that the proposal would both reduce the power of national regulatory supervision and potentially create unnecessary operational risk.

**Merging Funds – mergers between funds will also be facilitated in order to create economies of scale:**

In order to facilitate cross-border fund mergers and increase the size of the average UCITS, the proposals create a standardised European framework for fund mergers that is applicable on both cross-border and domestic funds and the basic principle is that all UCITS are entitled to merge, regardless of current structure. If the merger involves more than one merging UCITS and such UCITS are domiciled in different Member States, the competent authorities of each merging UCITS will need to approve the merger in close cooperation with each other and in any event, the merger must be authorised by the competent authorities of the merging UCITS home Member State. Any legal, advisory or administrative costs associated with the preparation and completion of the merger shall not be charged to either UCITS or the unit holders – all costs must be borne by the investment manager.

**Key Investor Information Document – the simplified prospectus will be replaced with a "Key Investor Information" ("KII") document, which contains fair, clear and not misleading information:**

The ‘Key Investor Information’ document is set to replace the Simplified Prospectus currently required for all UCITS, with a view to aiding the investor by enhancing transparency and comparability through this short and standardised fact sheet which must use non-technical language. The draft proposal regarding the Key Investor Information document specifically states that the document must be written in a “brief manner”, that it can be available in electronic form only (previously it had to be in hard copy) and that, even when a UCITS is marketed across Member States, only the home Member State has to approve the Key Investor Information document.
Supervisory cooperation:

To achieve regulatory alignment and reduce administrative burden, the UCITS IV Directive aims to build collaboration between regulatory authorities. Under UCITS III the level of correspondence between authorities was foreseen but less far-reaching than that of the UCITS IV Directive.

Conclusions:

Even though UCITS was only intended to ease the marketing of funds across the European Union, the UCITS brand is now recognised as the only truly globally distributed investment fund product. As a result, an increasing number of investment managers are establishing UCITS funds with a clearly defined global distribution strategy.

UCITS III has seen the proliferation of “hedge fund lite” structures (i.e., UCITS funds put in place by managers that achieve leveraged absolute return effects within the regulatory framework that UCITS provides). That framework however (particularly the liquidity requirements – no 90 days’ notice – and risk diversification – certain asset classes, such as loans and unlisted shares, don’t easily work in the framework) cannot allow some hedge fund strategies to work effectively. Clearly, if the AIFM Directive comes into force in its current form, there may be added attraction to hedge fund managers to shoehorn their products into UCITS form: not only will distribution be broadened but potentially the strictures of that AIFM Directive can potentially be sidestepped.

Meanwhile, for more traditional fund managers, there are strong hopes that the implementation of the UCITS IV Directive will encourage greater investor accessibility through the Master-Feeder structures, reduced administrative costs, larger funds and ultimately a more open market in the European Union and globally.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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3 Based on text at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/misc/108674.pdf: Adoption by the European Council was achieved on 22 June 2009; following publication in the Official Journal, the Member States have until 1 July 2011 to implement the Directive into domestic law.


7 CESR/07-434, ‘Guidelines concerning eligible assets for investment by UCITS: The classification of hedge fund indices as financial indices’ (July 2007).

8 CESR/09-489, ‘CESR’s technical advice at level 2 on Risk Measurement for the purposes of the calculation of UCITS’ global exposure’ (15 June 2009).


10 ‘UCITS IV – Passport to freedom?’, Financial Times (2 March 2009).