

CONTENTS

Background	2
UCITS' History	3
Changes from UCITS III to IV	4
Market Impact	8

UCITS IV

*Building on firm foundations***Foreword**

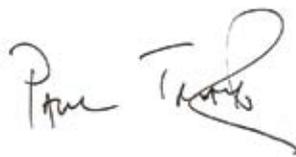
The success of UCITS as a brand is unquestioned. We believe UCITS IV will further enhance the appeal of the brand, building on firm foundations. On their own, the changes in legislation from UCITS III to UCITS IV will drive significant change, increasing both competition and efficiency in the funds industry. We suspect the current turbulent market conditions will act as a further catalyst, speeding up this change and perhaps increasing the brand's appeal.

The European Commission has estimated that the new form of direct notification between regulators could save the industry several billion euros. It should speed up registration for new funds and enable consistency of approach across Europe. It will also lead to increased competition with fund managers registering their funds in more countries and may encourage new entrants. Might hedge fund managers, chastened by the credit crunch but enticed by UCITS III's broadened range of instruments and the new notification process, now turn to UCITS as a "cloak of respectability" for their less leveraged vehicles?

We expect the provisions relating to mergers and master-feeder structures will drive much needed fund consolidation. This will enhance the industry's efficiency and help alleviate the consumer confusion created by duplicated structures and strategies.

Will the management company passport see the emergence of a third (lower cost) cross-border domicile to challenge Ireland and Luxembourg? In the medium term, Ireland and Luxembourg will continue to benefit from their existing scale. Although not directly analogous and despite some local challenges, recent ponzi schemes in other jurisdictions demonstrate the benefits of domiciling in a location with deep professional experience and access to well capitalised depositary banks.

Most importantly, we believe UCITS IV to be in the interests of the retail investor.



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Background

The European Parliament approved, on 13 January 2009, a proposed reform of the UCITS directives. The reform aims to make the investment fund market in the EU less fragmented and improve its efficiency.

The EU framework for these investment funds, originally set up in 1985 and updated several times since then, was intended to allow a real single market in investment funds to develop – since the funds all complied with the same rules, consumers could invest with confidence across EU borders. The rules increase investor protection and cost transparency, and set out basic requirements on organisation, management and oversight of funds.

The products have been a success: At the end of September 2008 investors held approximately \$6.7trn in UCITS vehicles (Source: EFAMA Investment Fund Industry fact sheet).

The key changes to the current UCITS III legislation are to:

- Remove administrative barriers to cross-border distribution of UCITS funds;
- Create a framework for mergers between UCITS funds;
- Allow the use of “master-feeder” structures;
- Replace the “Simplified Prospectus” with a short “Key Investor Information” document;
- Improve co-operation mechanisms between national supervisors; and
- Introduce a “management company passport” allowing funds authorised in one Member State to be managed remotely by a management company established in another Member State.

The UCITS IV regulation is subject to the Lamfalussy legislative process. The Lamfalussy process was designed to make EU legislation on securities markets more flexible, so that it can be agreed and adapted more quickly; to allow the EU institutions to benefit from the technical and regulatory expertise of European securities regulators and from better involvement of external stakeholders; and to focus more on even implementation and enforcement of Community law in the Member States.

As the European Parliament has formally approved the directive the first level of legislation has been accomplished. The legislative process consists of a total of four levels. Most national and EU fund industry bodies (including IFIA, ALFI and EFAMA) advise the responsible legislators throughout the process.

Figure 1:

	Legislative content	Completion (planned)	Responsible
Level 1	Broad framework and principles	13 Jan 2009	EU Parliament
Level 2	Implementing rules	31 Jul 2010	EU Commission, Committee of European Securities Regulators (CESR)
Level 3	Co-operation rules		CESR + national regulators
Level 4	Transposition into national law	31 Jul 2011	National legislators

UCITS' History

The first UCITS directive was adopted in 1985. It aimed to create a single market for funds in Europe. However, different marketing rules in each member state and limited permissible investments hampered the possibilities of the vehicle's growth and acceptance. Efforts in the 1990s to address these limitations led to a draft UCITS II directive. However, that legislative proposal was abandoned in 1997, as it was too ambitious to receive member states' support.

The current version of the legislative framework is UCITS III. This directive was passed into law at the end of 2001 and consists of two main elements:

- The Management Company Directive defines the scope of activities and rules of conduct of a "passport" management company. It requires the management company to be established in the domicile of the fund it is managing. The directive also introduced the "simplified prospectus", aimed at facilitating the cross-border marketing of UCITS funds
- The Product Directive increases the scope of eligible assets in which UCITS funds can invest, e.g. derivatives. It also sets new investment restriction limits, conditions for exposure calculation and stipulates new risk management obligations

UCITS III has had a profound impact on the fund landscape in Europe and beyond. New fund types emerged and cross-border distribution mushroomed. However, the overall cost of European funds has remained high compared to US funds. This is partially because European funds are smaller on average than their US counterparts, and partially because distribution costs are higher.

As an example, UCITS III removes the opportunity for member states to impose further documentation requirements on funds from other domiciles. However, UCITS III has not removed the requirement for separate filings in different domiciles. A promoter with a fund range domiciled in Ireland, for example, who wants to distribute into the rest of Europe is required to file the fund prospectus in all countries whenever there is a change to the prospectus. The change may be the addition of a new fund or changing an existing fund's investment objectives. Such is the breadth of this task that promoters employ full time resources and specialised external agencies to co-ordinate this work.

Changes from UCITS III to IV

The changes in the legislation from UCITS III to IV are comprehensive. The main changes are the management company passport, new merger rules, permission of master-feeder structures, enhanced supervisory co-operation, and the introduction of the Key Investor Information documentation.

Management company passport

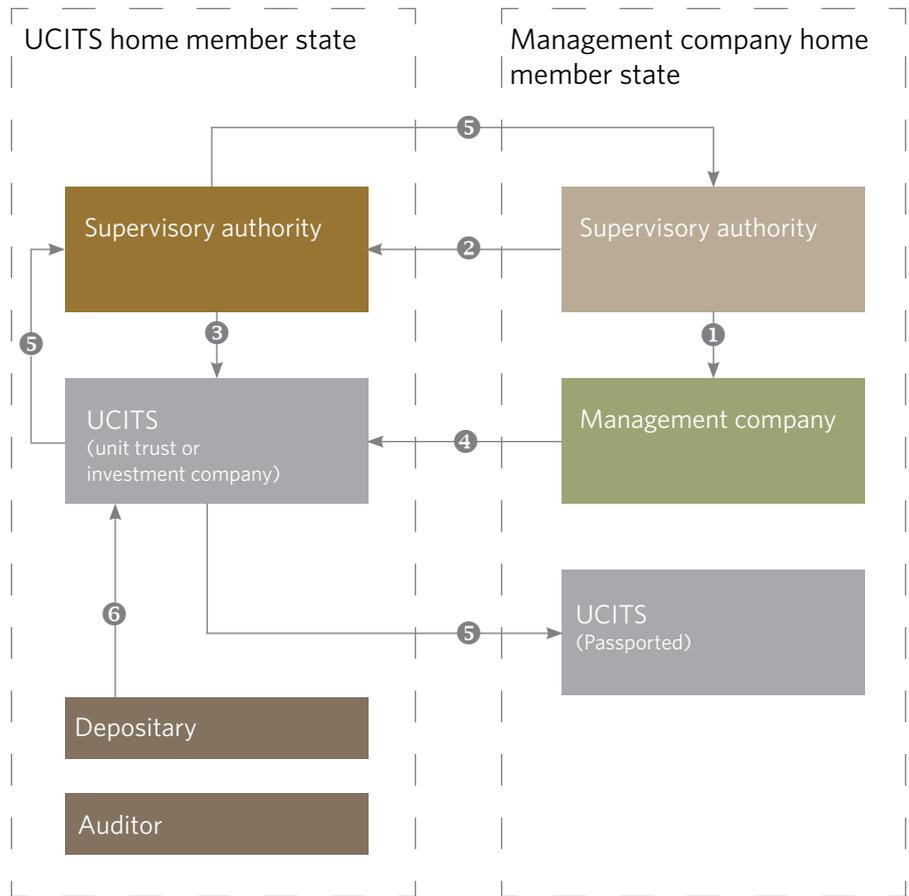
A UCITS fund management company must be authorised to carry out its business. It is the home member state of the management company that must perform this authorisation. Once the permission has been granted to carry out its activities those activities can be carried out for funds domiciled in any member state. For instance, a UK authorised management company is allowed to manage a fund domiciled in Luxembourg, Germany, France etc. Equally, a French management company is allowed to manage a fund domiciled in the UK, Luxembourg, Germany, etc. Therefore the supervisory authority of the fund may be different from the supervisory authority of that fund's management company. The supervisory authority of the management company's home member state requires the management company to have sound controls and procedures which are appropriate to the management of the specific UCITS, i.e. the supervisory authority must know both the management company and the UCITS it manages.

The management company may delegate one or more of its functions to a third party. If a management company delegates any function then the supervisory authority of the management company's home member state must immediately inform the supervisory authority of the fund's home member state. However, it is the management company's home member state that permits the delegation, not the UCITS home member state. The management company must have substance and its liability is not reduced through the delegation of functions. The management company must also "set up appropriate procedures and arrangements to make information available at the request of... the UCITS home Member State" (Source: European Parliament legislative resolution of 13 January 2009). The management company must comply with the rules of the UCITS home member state for:

- The establishment and authorisation of UCITS;
- The issuance and redemption of units and shares;
- Investment policies and limits, including the calculation of total exposure and leverage;
- Restrictions on borrowing, lending and uncovered sales;
- The valuation of assets and the accounting of UCITS;
- The calculation of the issue price and/or the redemption price, and rules regarding errors in the calculation of the net asset value and the related investor compensation;
- The distribution or reinvestment of the income;
- The disclosure and reporting requirements of UCITS, including the prospectus, the key investor information and the periodic reports;
- The arrangements made for marketing;
- The relationship with unit holders;
- The merging and restructuring of UCITS;
- The content of the unit-holder register;
- The licensing and supervision fees regarding the UCITS; and
- The exercise of unit holders' voting rights and other unit holders' rights in general.

The European Parliament has requested The European Commission to define further procedures and guidance on this topic by 1 July 2010.

Figure 2: The new UCITS IV Landscape - Management Co.



- ① The supervisory authority of UCITS host member state authorises the management company
- ② The supervisory authority of the UCITS home member state receives attestation from the supervisory authorities of UCITS host member state that the management company has been authorised
- ③ The supervisory authority of the UCITS home member state authorises the UCITS
- ④ The management company provides investment management, administration and marketing services to the UCITS. These services may in turn be outsourced to 3rd parties
- ⑤ The UCITS may be distributed (passported) into any EU member state, including the management company home member state. If a UCITS wants to distribute into another member state then it needs to notify its home supervisory authority who in turn will notify the supervisory of the host member state
- ⑥ The depository acts independently and in the interest of unit holders to safeguard the fund's assets

In the context of the management company provisions it is important to mention the role of the depositary, which effectively will not change, i.e. the depositary must be established in the UCITS home member state and have an agreement in place with the management company regulating the flow of information between the two. In effect, the depositary must have guaranteed access to the books and records of the fund in whatever jurisdiction they reside. This is to ensure that the depositary has all the information it needs to verify continued compliance with the risk profile of the fund, regulatory requirements, and the information and requirements contained within publicly disclosed documents.

Mergers

The UCITS IV directive covers both domestic and cross border fund mergers. The merger techniques used may vary from one Member State to another. However, it is the laws of the merged UCITS' member state that will guide the merger.

The directive describes the notification process between the supervisory authorities in the “receiving” home member state and “merging” home member states. The process also sets out maximum timelines for the processing and the content of the merger documentation including:

- Identification of the type of merger and of the UCITS involved;
- The background and the rationale for the proposed merger;
- The expected impact of the proposed merger on the unit-holders of both the merging UCITS and the receiving UCITS;
- The criteria adopted for valuation of the assets and, where applicable, the liabilities on the merger effective date;
- The calculation method of the exchange ratio;
- The planned effective date of the merger;
- The rules applicable respectively to the transfer of assets and the exchange of units; and
- Where applicable, the fund rules or instruments of incorporation of the newly constituted receiving UCITS.

The depositary and the auditor of the merging UCITS need to validate the criteria for calculation of the assets and liabilities, the cash payment per unit, and the exchange ratio. The directive also sets out the information that must be provided to unit-holders of the merging UCITS.

Merger costs must not be charged to the UCITS, except where the UCITS does not have a designated management company.

Master-feeder structures

The UCITS IV directive defines a feeder fund as a fund that has been approved to invest at least 85% of its assets in another UCITS. The remainder of the assets may be invested in cash, derivatives (for hedging purposes only), or property for its own use. A master fund is defined as a fund that must have a feeder fund as a unit-holder, must not be a feeder, and must not hold units of a feeder fund. It is the supervisory authorities of the feeder's home member state that must approve the fund's status as a feeder. This approval has to be given within 15 days of the submission of the application.

If the master and feeder funds have different depositaries and auditors, then those depositaries and auditors must enter into an information-sharing agreement (the value and appropriateness of such information agreements between depositaries has been questioned in circumstances where the depositary of the feeder fund may receive information which is not in the public domain, and therefore that feeder fund is obtaining an unfair advantage over other investors in the master fund). If the feeder and the master have different accounting years then the auditor of the master must make a special report for that fund on the closing date of the feeder fund.

In addition to the agreements required between the depositaries and auditors of the funds, an agreement will be required between the feeder and the master funds to ensure that the feeder is able to meet its regulatory requirements. The agreement must also ensure that any commission

paid to the feeder fund as a result of its investment (into the master fund) is paid into the feeder's assets and not to its management company.

The master fund will have to notify its regulator of the identity of any feeder funds. If the funds are in different countries then the master fund's regulator will notify the feeder fund's regulator of the investment. The feeder fund must make a number of disclosures relating to the master fund in its prospectus, including details of the investment objective/policy and costs relating to the feeder's investment into the master and any tax implications.

Cross-border marketing

The change in the notification process could be the most important change. It is proposed to introduce electronic notification between regulators and to allow marketing to start immediately once the home state regulator has notified the host state regulator. This will mean that regulators speak directly to each other rather than a fund manager having to facilitate, and at times intermediate, the communication between home and host state regulators. Currently, a fund manager must complete a notification procedure, filing a number of documents, often translated, with a host regulator if they wish to market a fund in that host state. The host state then has up to two months to approve the marketing of the fund in the state. Other implications of this change are that it should speed up registration and thereby improve speed to market and enable a more consistent approach across Europe. Currently, some countries take the full two months to approve a fund, others may do it the same day. Fund managers may now consider registering in more countries, leading to increased competition.

Key investor information

The Key Investor Information document is a short document designed to describe the fund. The directive emphasises that the documentation should be simple and easy to understand and contain:

- The name;
- A short description of the investment objectives and policy;
- A description of past performance or performance scenarios;
- Costs; and
- The fund's risk/reward profile.

UCITS III contained the notion of a "simplified" prospectus. However it turned out that those documents weren't that simple after all, and there is much variation in format and content between countries. UCITS IV therefore seeks to make amends in this respect. The European Commission is charged with defining the detailed content and format of the key investor information document by 1 July 2010.

Supervisory co-operation

Under UCITS IV, the supervisory authority of the UCITS home member state effectively relinquishes some of its authority to the supervisory authority of the management company's home member state. In order not to achieve "split" authority, the directive calls for closer co-operation between the supervisory authorities of the UCITS' and management company's home member states. The regulators also receive broad powers to access any documentation, data traffic records, etc. that may be required for any investigation. If a supervisory authority in one member state suspects that the directive is not adhered to by some entities, which are not subject to its supervision, then it must inform the regulator of the relevant member state. The latter must report back on the remedial actions it has taken and the outcome of those actions. The regulator who suspects breaches may also request that its own staff members take part in the investigation carried out by the regulator in the other member state.

Market Impact

UCITS IV is likely to have far reaching impacts on the fund markets in Europe and beyond. The changes in the UCITS directive will probably enhance the brand, although the importance of domiciles may weaken. The paragraphs below explore the potential consequences.

Fund consolidation

As at 30 September 2008, there were 37,475 UCITS funds with net assets of \$6.7trn. The average UCITS fund therefore has net assets of approximately \$180mn. In the US there were 8,054 funds as at 30 September 2008, and the average net assets were more than seven times higher at \$1.3bn (Source: EFAMA, BNY Mellon Analysis). Fund costs are not linear to fund asset size. This means that a small fund has proportionately higher costs than a large fund. At an industry level the cost difference between the US and Europe is therefore very significant. This disadvantages the European investor and ultimately leads to lower returns for European savers.

The European Commission is aware of this and, through the UCITS IV directive, seeks to encourage UCITS funds to consolidate. It is, in particular, the provisions for cross-border mergers and master-feeder structures that will make this consolidation easier for industry participants to carry through.

The current market environment will also accelerate the trend towards consolidation, independently of UCITS IV, as investment managers are forced to look very hard at the overall cost structure of their product range. From an investor perspective a reduced number of funds could be to their benefit as it will reduce the number of duplicated strategies available within countries and therefore make investment choices clearer.

Higher market share for UCITS funds?

UCITS III has been a phenomenal success. These funds are not only domestic, intra-EU, investment vehicles, but are also used as savings vehicles by investors in more than 30 countries outside the EU. The EU UCITS fund industry enjoyed spectacular growth in the period 1997-2007 when CAGR asset growth averaged 15% (Source: EFAMA, BNY Mellon Analysis). These growth rates went into reverse in 2008 and it is unclear when they will pick up again. There are two major threats to future growth:

- Market performance may not improve. Although UCITS funds can borrow and use derivatives, they are not as flexible as hedge funds in exploring market trends. This is of course part of their attraction from an investor protection point of view.
- The competition from other investment vehicles is increasing, e.g. from Ireland and Luxembourg QIFs and SIFs, and from structured products in all jurisdictions.

Mutual fund ownership in the EU is, on average, still lower than in the US. One of the reasons for this is the universal banking model in Europe where a bank may be more inclined to promote deposits over fund investments. This is especially true in the current market environment where banks are reliant on deposits to balance their funding sources. The other reason for lower fund ownership in the EU, relative to the US, is that mutual funds are less frequently used as pension savings vehicles. In the US a large portion of defined contribution pensions are held in mutual funds through 401(K) schemes.

UCITS funds will continue to increase their attraction for investors in developing fund markets outside the EU. The UCITS legislative framework is the result of many years of continuous improvements. Many developing economies have simply not had the opportunity to develop their own fund legislation to the same standards. It is therefore easier for those countries to “adopt” the UCITS brand as it channels their savings into reliable vehicles, albeit those vehicles and assets are domiciled outside their own borders. This last point may also be a reason for China to be more reluctant to fully allow all its investors to access UCITS vehicles.

UCITS IV will reduce the overall cost of fund ownership and make funds more competitive as an investment vehicle. However, this trend may not be enough to stem the tide away from actively managed funds, especially equity, bond, and balanced funds. The last 18 months have seen very significant outflows from UCITS equity funds. Some of these outflows are due to the credit crisis and investors' flight to other asset classes with lower risk profiles. However, the flows may be indicative of a longer-term trend away from actively managed UCITS funds. The continued strong inflows into ETFs support this argument.

Will domiciles become less relevant?

UCITS IV will not create an "EU" domicile. However, UCITS IV's chapters on management company passport, cross-border mergers, master-feeder structures, and supervisory co-operation could all undermine the stronghold of both local and cross-border domiciles.

The management company passport is likely, other things being equal, to reduce the fund industries in the cross-border domiciles, Ireland and Luxembourg. As the management company no longer has to be domiciled in those locations, the full management of the fund can stay in the financial centres where the investment management functions have been carried out until now. These are mainly the capitals of the largest EU economies. The German, UK and French economies are generating the largest investable asset pools and the largest asset management firms quite naturally originate in those countries. The management company passport therefore breaks down a, perhaps somewhat artificial, construct where some of the fund management functions physically had to be located in a fund's domicile. Many investment managers outsourced the functions that were required to be in the fund's domicile to "management company" service providers.

The cross-border domiciles are likely to benefit from their existing scale and experience. Both Ireland and Luxembourg have very professional fund industry participants, including lawyers, auditors, administrators and custodians, trustees, the regulator, and industry associations. Additionally, as the fund industry has become an important part of their local economies, the Irish and Luxembourg governments are strong supporters and will often proactively legislate in favour of the industry. This has created a positive reinforcement effect where even more funds have been domiciled and consolidated there to take advantage of the favorable environment. Luxembourg has become the pre-eminent cross-border domicile. On the other hand Ireland has become an administration centre in its own right, often for funds that are not domiciled there. In fact the Irish fund industry administers more non-domiciled than domiciled assets.

Supervisory co-operation may become either the foundation or the Achilles' heel of the directive. Standards need to be clear and consistent in order to avoid regulatory arbitrage. Regulators who pioneer new supervision standards, for example the UK's FSA, may attract both new funds and investment management companies to their domicile.

UCITS IV facilitates cross-border mergers. A merging German and Luxembourg fund is more likely to merge into a Luxembourg fund than into a German fund as the Luxembourg fund range is more readily accepted for cross-border distribution, for example into the UK and Asia. This will accelerate an already existing trend to reduce "domestic" ranges in favour of cross-border ranges, i.e. those domiciled in Luxembourg and Ireland. This reduction will result in significant fund closures and in/out specie transfers. Likewise, the UCITS IV master-feeder structures are likely to have masters domiciled in the cross-border domiciles with feeders domiciled elsewhere.

Local domiciles may end up having fewer assets domiciled within them and the role of the cross-border domiciles may weaken. More fund management and administration functions may be carried out outside the domicile, for example in the country of management or in countries where the carrying out of a certain function is less expensive, or more efficient.

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