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UCITS is possibly one of the European Union's most successful legislative frameworks. The rules increase investor protection and cost transparency, and set out basic requirements on organisation, management and oversight of funds. But, most importantly, and in line with the desire to create a single market in investment funds, the EU fund passport was created. Consumers can now invest with confidence across EU borders, since all funds comply with the same rules.

The first UCITS directive was adopted in 1985. 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 the fund's 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 have emerged. The current move to create wrap hedge fund strategies into UCITS vehicles is still based on the legislative framework from nine years ago. This may be why the term "Newcits", which is sometimes used to describe these vehicles, is often mentioned between inverted commas — the concept behind these fund isn't that new at all. Nevertheless, it is a proof of the enduring broad relevance of the UCITS III directive, which was designed long before the financial crisis, that hedge fund promoters now create fund products for sophisticated investors which avail themselves of its liquidity and investor protection measures.

Another, probably unintended, consequence of this strong legislation is its popularity outside its intended application area. More than 30 countries outside the EU now allow their citizens to invest in EU domiciled funds.

UCITS IV — A New Beginning?

From One to Three to Four

And, by some estimates, more than a third of net sales into UCITS funds are generated from countries outside the EU. UCITS has therefore, in some ways, become a global funds framework. At the end of March 2010, investors held US\$7.6 trillion in UCITS vehicles¹ and the management and administration of these assets hugely benefits the European fund industry and therefore the European economy.

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. The European legislators are aware of these issues and have therefore aimed to make the investment fund market in the EU less fragmented and improve its efficiency. So, on 13 January 2009, The European Parliament approved a proposed reform of the UCITS directives — UCITS IV. The legislation comes into effect in July 2011 (except for a grandfathering rule concerning the Key Investor Information). The key changes to the current UCITS III legislation are to:

- 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.
- 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.

A New Beginning?

On the face of it, the changes from UCITS III to IV do not appear fundamental. But, although the direct legislative changes may be limited (despite several hundred pages of text), their impact on the investment fund market could become very significant. UCITS IV is, however, not alone in changing the industry. We are in a period of unprecedented legislative reform of the financial services industry and it is a combination of all these reforms that will shape the fund market going forward. We have considered some of the changes which might occur.

The cross-border distribution of funds is likely to increase. There are two reasons for this. Firstly, UCITS IV will not damage the strong UCITS brand. Fund managers currently using UCITS vehicles to gather assets across the world will continue to do so going forward. Secondly, those managers outside Europe who have hitherto launched vehicles in their home domiciles for domestic distribution are considering launching UCITS funds. They, and these are especially Asian fund managers, can use UCITS funds for distribution in both their domestic market and all other UCITS markets. The largest EU cross-border domiciles, Ireland and Luxembourg, are likely to be the main beneficiaries of this trend as host regulators outside of Europe are already accustomed to receiving applications for distribution from these countries.

¹ Source: EFAMA Investment Fund Industry fact sheet

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Investor communication requirements will change. The Key Information Document will, at least initially, incur significant cost to the industry. The European legislator's intention is to make it easier for investors to be able to understand the product they will be buying and to easily compare its price, performance and risks with similar products. So, the cost of changing from the simplified prospectus to the Key Information Document is probably worth incurring, if it helps to avoid mis-selling and ultimately leads to better investment outcomes for the investor. This is especially relevant in the context of a potentially increased risk of mis-selling of hedge funds in UCITS wrappers. Hedge funds can in principle only be sold to sophisticated investors under private placement regimes but have now become available to broad retail investor constituencies through UCITS funds.

The management company infrastructure will change. A fund's management company currently has to be located in the country of the fund. UCITS IV changes that. From July 2011, a fund can be managed cross-border from any other EU jurisdiction. This will, in principle, lead to fewer management companies in Europe as a fund manager need only have one in order to manage funds in any number of EU domiciles. There are practical obstacles, for example tax, associated with the consolidation of management companies, but the trend is clear: there will be fewer, not more. But, although there will be fewer management companies, those which remain will have to increase their substance and become MiFID (Markets in Financial Instruments Directive) compliant. The centralisation of management companies will also extend to those functions which the management company might outsource, such as administration. Administrators may, for example, provide administration from any country to a fund in any other EU fund domicile, provided that the outsourcing rules covering the management company are adhered to.

Funds will be consolidated. This trend has already started as the financial crisis and reduced profitability has forced investment managers to look very hard at the overall cost structure for their product range. The 37,638 UCITS funds at the end of 2008 shrank to 36,122 funds at the end of March 2010². This is despite the fact that new funds in general still sell much better than back-list funds and that fund managers therefore, costs allowing, would prefer to continue a high rate of new launches. UCITS IV will probably accelerate funds consolidation, or at least asset consolidation at the portfolio level. The UCITS IV cross-border merger provisions which were intended to be a key tool for consolidating funds seems to be watered down by tax obstacles and the disincentive that merger costs must be absorbed by the fund manager and not the fund itself. The master-feeder provisions, on the other hand, seem to have become a major tool in managers' fund rationalisation strategies.

Overall, version four of this already phenomenally successful legislative framework will further increase the appeal of UCITS funds to retail, high net worth, and institutional investors — and not only in Europe, but across the world. But, the current scale and form of the industry would have been difficult to predict when UCITS III came into effect in 2001, and the preparation for a UCITS IV world therefore requires continuous testing of change hypotheses and the meticulous planning and implementation of agreed change strategies.

² Source: EFAMA Investment Fund Industry fact sheet

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