



The Continuing  
Evolution of  
UCITS Funds

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## THE CONTINUING EVOLUTION OF UCITS FUNDS

### Introduction

UCITS (Undertaking for Investment in Transferable Securities) is the European harmonized fund product which can be sold on a cross border basis within the European Union (“EU”) based on its authorization in one EU member state. Ireland was one of the first EU member states to transpose the first EU UCITS Directive into Irish law when it did so in 1989. Ireland is now one of the leading domiciles for UCITS funds which are frequently promoted by US asset manager and marketed not just in Europe but globally.

The first EU UCITS Directive allowed for a very basic product which was permitted to invest in transferable securities and only use derivatives for the purpose of efficient portfolio management. Accordingly, under the original UCITS regime, UCITS were essentially long only equity or bond funds. Nevertheless, it proved to be a very successful product in this section of the market and established a strong global brand as a regulated investment product. In the period since the first UCITS Directive, there has been significant amending legislation and regulations permitting UCITS to offer a far broader range of investment strategies while still maintaining its global brand as a regulated investment product which enables UCITS to be sold not just in Europe but also in other significant markets such as Asia and South America.

EU Directive 2001/108 (which is commonly referred to as the “**Product Directive**”) introduced significant developments to the UCITS product. It broadened the range of assets in which a UCITS may invest and the investment strategies which it may pursue. The Product Directive expanded the types of instruments in which a UCITS may invest to include money market instruments, other funds (both UCITS and Non-UCITS) and bank deposits. It also permits the establishment of index tracking funds and the use of financial derivative instruments for investment purposes rather than merely for efficient portfolio management.

In accordance with the Product Directive, a UCITS’ maximum potential exposure relating to derivative instruments should not exceed its total net asset value. The EU Commission has recommended that a UCITS which uses financial derivatives instruments in a non-sophisticated manner (i.e. only use a limited number of simple derivative instruments for non-complex hedging or investment strategies) may use either, (i) a commitment approach (where the derivative positions of the UCITS are converted into the equivalent position in the underlying assets relating to the derivatives, which may be netted) or (ii) an advanced risk

management approach such as Value-at-Risk (“**VaR**”) to measure its potential exposure through the use of derivatives.

A UCITS which is a sophisticated user of derivatives must use an advanced risk management approach to calculate its potential exposure through the use of derivatives. The Irish Financial Services Regulatory Authority (the “**Financial Regulator**”) permits the use of either Relative or Absolute VaR for this purpose. Relative VaR is the VaR of the UCITS divided by the VaR of a benchmark or reference portfolio (i.e. a similar portfolio with no derivatives) which may be an actual benchmark (such as an index) or a fictitious benchmark. In the case of Relative VaR, the VaR of the UCITS should not exceed twice the VaR of the benchmark. In the case of Absolute VaR (the VaR of the UCITS capped as a percentage of NAV) the Financial Regulator generally permits an Absolute VaR of up to 20% of the Net Asset Value of the UCITS provided it has a holding period of 20 days and a confidence level of 99%.

The growth of UCITS funds investing in the broader range of instruments outlined above and using financial derivative instruments for investment purposes has been further assisted by the Committee of European Securities Regulators (“**CESR**”) issuing guidance and clarification on how such instruments may be utilized by UCITS. For example CESR has clarified that closed-ended funds may be treated as transferable securities (provided they meet certain criteria) and are therefore permissible investment for UCITS. It has also clarified that both commodities and hedge fund indices qualify as financial indices provided they meet certain criteria which include that they are (i) sufficiently diversified, (ii) represent an adequate benchmark for the market to which they refer and (iii) are published in an appropriate manner.

The latest EU UCITS Directive (commonly referred to as “**UCITS IV**”) has just been passed by the European Parliament and is expected to be formally approved by the EU Council very shortly. Once approved by the EU Council, each EU member state will be required to transpose it into their national law by 1 July 2011 at the latest. UCITS IV will introduce the following changes to the UCITS regime:

## UCITS Passport

The current UCITS regime provides for a procedure pursuant to which a UCITS is required to notify in advance the regulator in the relevant EU member state in which it intends to market its shares. This is referred to as the UCITS Passport. This process is supposed to be subject to a two month time limit. In practice it can take slightly longer in a number of EU

member states. In 2006 CESR issued non-binding guidelines to simplify the process and seeking to have all EU member states process passport notifications in as short a period as possible. This has helped to simplify the process thereby reducing the costs incurred and the time of getting to the relevant market. However, under UCITS IV, the process will be further simplified. A UCITS will no longer have to deal with the regulator of the EU member state into which it intends to market its shares. Instead, it will notify its own regulator who will make the formal notification to the regulator in the other relevant EU member state within 10 days. The UCITS may commence marketing its shares in the other EU member state with effect from the date on which its regulator notifies the other regulator. This should be a far more efficient passport procedure.

## Cross-border Mergers of UCITS and UCITS Master-Feeder Structure

A UCITS master-feeder structure is not possible under the current UCITS regime. Nor does the current UCITS regime provide procedures for the merger of UCITS on a cross-border basis. As a consequence, difficulties can be experienced in achieving a merger of UCITS located in different EU member states. UCITS IV provides for a UCITS master-feeder structure and a cross border merger process. This will facilitate consolidation of UCITS funds which will provide economies of scale (traditionally the average size of UCITS funds would be smaller than the average US mutual funds and consequently have higher operating expense ratios).

## New UCITS Management Company Passport

A UCITS management passport procedure was first introduced by EU Directive 2001/107 (the "**Man Co Directive**"). The intention of the management company passport was to allow a UCITS management company to provide its services in EU member states (other than the one in which it is authorized) by a notification procedure to the regulators in the other EU member states into which it intends to provide its services. However, due in large part to a lack of clarity in key provisions of the Man Co Directive the UCITS management company passport as provided for in the Man Co Directive has not been effective. Following much debate about the structure of the passport within the industry in Europe, UCITS IV has introduced a revised management company passport which it is intended should provide for a full and effective management company passport.

## Key Investor Information

Under the current UCITS regime, UCITS funds are required to have a Simplified Prospectus which is required to contain certain key information which should be easily understood by the average investor. This document is supposed to be a short document which can be used in each EU member state where a UCITS markets its shares. In practice the Simplified Prospectus has not been as successful as it has been hoped because the format was not prescribed and different EU member states have adopted different formats which vary in content and length. Under UCITS IV, the Simplified Prospectus will be replaced by the Key Investor Information which will be a short concise document. Its content will include (i) a short description of the investment objectives and policies of the UCITS, (ii) information on past performance, (iii) details of costs and charges (iv) risk profile appropriate to the investment policies of the UCITS and (v) details of where the full prospectus and additional information about the UCITS may be obtained. This document should assist in marketing a UCITS throughout the EU and elsewhere.

## Supervisory Co-Operation

The original UCITS Directive simply provided that regulators in each EU member state should collaborate with each other. UCITS IV will introduce a clear framework for such collaboration which ought to further harmonize the operation of UCITS on an EU wide basis.

While UCITS has evolved and become more flexible (as outlined above), it has still managed to maintain its global brand as a regulated investment product. Consequently, at a time when legislators in the US and EU are considering introducing regulation of hedge funds and investors are increasingly seeking greater transparency and risk controls (including independent custodians) many fund promoters (including those who may have to date operated in the alternative sector) are looking to UCITS, as a regulated product that can be sold on a global basis, to form an important part of their range of products.

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*For more details on how we can help you, to request copies of most recent newsletters, briefings or articles, or simply to be included on our mailing list going forward, please contact any of the team members below.*

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