

UCITS IV: The
Next Phase in
the Evolution of
UCITS

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Introduction

UCITS IV is the latest step in the European Commission's UCITS (Undertakings for Collective Investment in Transferable Securities) project to create a genuine pan-European single market for investment funds. The UCITS project has certainly been successful: UCITS represent about 75% of the EU investment fund market with assets under management amounting to around €6 trillion. One of the primary aims of the draft UCITS IV Directive is that fund management firms would be able to pool and market funds more freely and easily through the twenty seven Member States of the European Union ultimately leading to significant cost reductions for the industry and the investor.

To date, however, the road towards a new UCITS IV Directive has not been smooth. The draft UCITS IV Directive had originally been scheduled for publication no later than 30 April, 2008 but was not actually published until the 16th of July of this year. The most radical proposal, the "Management Company Passport", was left out of the initial draft due to objections from a number of Member States most notably Ireland and Luxembourg.

The Management Company Passport

It is proposed that a UCITS management company could operate from a single jurisdiction within the EU and passport their services to funds operating in other Member States thereby achieving both economies of scale and better internal controls and risk management. However, there were differing opinions as to how this would work in practice since some Regulators felt that they could not ensure adequate compliance with their requirements where management companies were operating outside their jurisdictions. Other concerns were expressed that such arrangements could make it difficult for a UCITS fund itself to ensure that it operated in accordance with the rules under which it is constituted.

Accordingly, the Management Company Passport proposal has been omitted from the current draft of the Directive and the Committee of European Securities Regulators ("CESR") has been given a deadline of 1 November, 2008 to advise the commission on the "the structure and principles which could guide potential future amendments" to the UCITS IV Directive in relation to the Management Company Passport. CESR recently announced that it will conduct an open hearing at its headquarters in Paris on the 13 October, 2008 to consider the following aspects of the Management Company Passport:

- a) Definition of domicile;
- b) Applicable law and allocation of supervisory responsibilities;
- c) Authorisation procedure for UCITS funds whose management company is established in another Member State;
- d) On-going supervision of the management of the fund; and
- e) Dealing with breaches of rules governing the management of the fund.

We await the outcome of this hearing to see whether these issues can be resolved to the satisfaction of all stakeholders. It should be noted that there is widespread determination to incorporate the Management Company Passport within the final UCITS IV Directive as it enjoys support from most Member States, many investment management trade associations in Europe and from the European Fund and Asset Management Association (“EFAMA”).

Key Features of the Current Draft UCITS IV Directive

The draft UCITS IV Directive as it now stands contains the following key proposals which we will outline here:

- ▣ Improved Cooperation Mechanisms
- ▣ Streamlined Fund Notification Procedure
- ▣ Master Feeder Structures
- ▣ Fund Mergers
- ▣ Key Information Document (the “KID”)

Improved Cooperations Mechanisms

A feature of the current UCITS Directive has been the cooperation between Member State Regulators at CESR level. It is generally felt that this has made the interpretation and implementation of UCITS rules and regulations simpler and more consistent across the European Union. It is proposed that, in line with the increased freedoms under the draft UCITS IV Directive, existing mechanisms relating to the exchange of information should be built on and in certain circumstances allow the Regulator in one Member State to carry out verification of information relating to the UCITS Directive within the territory of another Member State or have the Regulator in another Member State carry out such checks (subject to the actual provisions of the UCITS IV Directive when finally implemented).

Streamlined Fund Notification Procedure

It is a common complaint that the fund passport and notification procedure under the current UCITS Directive is not as smooth and efficient as it might be. EU Member States often impose extra requirements which cause delays and increase costs therefore reducing the effectiveness of CESR's attempts to cure these problems.

The UCITS IV proposals revamp the current procedure considerably and should radically reduce delays and costs. In summary, a UCITS fund seeking to market in another Member State must notify its Home Regulator in writing, and also provide it with a set of constitutional, financial and prospectus documentation (which should also be translated as appropriate). The Home Regulator must verify the completeness of the information and transmit it to the Host Regulator within one month. Once the Home Regulator confirms this notification has been made to the Host Regulator the UCITS can begin marketing its units and the Host Regulator cannot request further information at this point. However, once the UCITS has begun marketing its units the Host Regulator may check that this is conducted in accordance with national rules.

Master Feeder Structures

The current draft UCITS IV Directive, if implemented, will enable one or more feeder funds to pool their assets in a single master fund. The rationale for this proposal is that it would allow UCITS funds to have increased economies of scale and lower operational costs.

There will be a number of rules under UCITS IV applicable to any UCITS Master / Feeder, for example:

- ▣ The master and each of the feeders must each be established as UCITS funds;
- ▣ Each feeder fund is also required to invest at least 85% of their assets into the master fund;
- ▣ To avoid the creation of opaque structures the master fund may not be itself a feeder fund nor may it invest in the units of another feeder fund;
- ▣ The Regulator of the feeder fund must approve its investment policy;
- ▣ The master fund must provide a declaration to the effect that it does not hold any units of a feeder fund as part of the approval process;
- ▣ If the master fund and the feeder fund are established in different jurisdictions, the feeder fund must also demonstrate that it is a UCITS fund and that it is not itself a feeder fund.

- ▣ The master fund and the feeder fund must enter into a legally binding agreement;
- ▣ The feeder fund and the master fund may have different custodians or auditors but if this is the case, the parties must enter into an information sharing agreement;
- ▣ The feeder UCITS must act in the best interest of its unit-holders and in doing so shall monitor effectively the activity of the master UCITS.

Fund Mergers

The draft UCITS IV Directive proposes that two UCITS funds, whatever their legal form and wherever located in the EU, should be permitted to merge subject to certain conditions which would be imposed for investor protection. European funds tend to be small in international terms and like many of the other UCITS IV proposals it is hoped that this measure will promote economies of scale. It remains to be seen how the legislation implementing the draft UCITS IV Directive will deal with the taxation of fund mergers as unit-holders will be concerned that the current treatment (whereby fund mergers do not constitute a capital gains tax event) continues.

The conditions and rules to which these mergers will be subject are set out in the draft UCITS IV Directive under Chapter VIII – Master-feeder structures, Articles 53 to 61. The Regulator of the merging entity is required to authorise the merger and is also required to consult with the Regulator of the receiving UCITS. In order to reach its decision (which must be reached within 30 days of the notification by the merging entity) the Regulator must receive the following documentation: the prospectus, key information document, draft terms of the merger -which must contain certain specified items of information, circular to unit-holders and a certificate which the custodians of both the merging and receiving entity must provide confirming that they have verified compliance of the terms of the draft merger with the UCITS Directive and the constitutive documents of the funds. The receiving UCITS must have notified the relevant Regulator of its intention to market its units/shares in the jurisdictions in which the investors in the merging fund are based. The information to be provided to investors must be provided not less than 30 days before the date of the general meeting (if relevant) or 30 days before the date of the merger. The entry into effect of the merger must be made public. No costs or expenses of this process are to be borne directly or indirectly by the merging or receiving UCITS or their unitholders.

Key Investor Document

The practice of some Member States of imposing their own rules in respect of Simplified Prospectuses has resulted in a document that is often overlong and not sufficiently user

friendly. The aim of the key investor document (or KID) proposed in the draft UCITS IV Directive is to create a uniform document that will communicate the relevant information to investors.

Appropriate product information about the UCITS concerned must be included in the KID so that investors are reasonably able to understand the nature and the risks of the product and, consequently, take investment decisions on an informed basis. The minimum information required under the draft UCITS IV Directive consists of: (a) a short description of its investment objectives and investment policy; (b) a past performance presentation; (c) details of the costs and associated charges; (d) a description of the risk/reward profile of the investment, including appropriate guidance on and warnings of the risks associated with investments in the relevant UCITS; and (e) details of where and how to obtain additional information. The key investor information should be kept up to date and Member States cannot require amendments to the KID other than translation.

The KID will contain a clear warning that a person does not incur civil liability solely on the basis of the key investor information, including any translation thereof, unless it is misleading, inaccurate or inconsistent with the relevant parts of the prospectus.

Interestingly, the draft UCITS IV Directive also provides that the KID be written in a brief manner and in non-technical language.

What's next?

Despite much media speculation earlier this year that UCITS IV would go the way of UCITS II (which famously never launched due to Member States' failure to agree a common position), the publication of the draft Directive in July would indicate that the European Commission is keen to move forward with the new proposals. A second draft Directive is likely to follow CESR's report on the Management Company Passport issue and 2011 has been mooted for the implementation of UCITS IV.

The text of the draft UCITS IV Directive can be found [here](#).¹

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¹ http://ec.europa.eu/internal_market/investment/docs/legal_texts/framework/recast_en.pdf

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Dillon Eustace recently published a similar article on the draft UCITS IV Directive in the August 2008 edition of Finance Magazine.

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