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The European investment fund industry has grown to be a major player in European capital markets and has significant potential for growth in the years ahead. Investment funds throughout Europe amount to over €5 trillion in assets.[1] The most common investment fund in Europe is known as UCITS (undertakings for collective investment in transferable securities), which account for over 70% of the assets under management by the fund industry in Europe.[2] In some EU member countries (the "Member States")[3] some investors are discovering investment funds for the first time.

The UCITS directives, the first of which was introduced in 1985 (the "original directive" or "UCITS I")[4], and later amended by two directives - the Management Directive[5] and the Product Directive[6] (collectively referred to as "UCITS III") - aim to establish investor protection through strict investment limits, capital and disclosure requirements and independent oversight procedures. The directives also allow a UCITS to operate under a "passport" system, whereby it can be offered for sale throughout the EU once it has been authorised in one Member State.

In addition to the progress made through the directives, the Commission of the European Communities (the "Commission") sought to improve the understanding and efficiency of UCITS by publishing its Green Paper in July 2005 (the "Green Paper").[7] Rather than proposing new legislation, the Commission hopes to improve the current UCITS III scheme with a view towards increasing its use and presence across borders.

This article summarises the original directive and two amending directives, describes efforts in place to improve the UCITS III scheme and presents a future outlook for UCITS in the European fund marketplace.

The original UCITS Directive

UCITS I was part of an early effort to create a uniform retail market for investment funds in Member States. The objective behind UCITS I was to establish a common market for a fund that met certain criteria:

- its sole objective must be collective investment in transferable securities;
- its capital must be raised through the public offering of interests in the fund;
- its securities must be subscribable and redeemable out of fund assets (i.e., it must be an open-end fund); and
- it must comply with certain prudential investment limits and investor safeguards.[8]

A fund that qualifies as a UCITS and is authorised by a Member State may then be marketed to the public in any other Member State following proper notification in the relevant Member States.[9]

As noted above, UCITS are limited to investments in "transferable securities," a term that was left undefined by UCITS I. In the absence of a specified definition, "transferable securities" had been interpreted to mean listed bonds and equities. The original directive required 90% of a UCITS' assets to be invested in transferable securities, while the remaining 10% could be placed in certain other investments.[10] UCITS I also greatly limited a fund's ability to borrow money.[11] By the terms of the original directive, a fund could not widely invest for speculative purposes in, among other things, shares of other funds, derivative products or money market instruments. Furthermore, due to diversification limitations inherent in UCITS I (i.e., generally no more than 5% of a UCITS' assets could be invested in a single issuer, absent an increase in this level authorised by an individual Member State), an index or tracker fund could not qualify as a UCITS.

In part because of these limitations, UCITS had limited success. The original directive succeeded in laying the groundwork for a single European market for investment funds and their registration and sale in other Member States. However, UCITS did not achieve the level of participation in the investment community that the Commission had envisioned. One reason was that the process for registering a UCITS was left to the discretion of each Member State, which led to considerable variance not only in the documentation required by regulators of a particular Member State but also the time regulators took to review and consider the product for approval in the respective Member State.[12]

This variance resulted in frustration for investment firms, especially those with UCITS umbrella funds that launched new sub-funds. In many cases, it was possible to be one or even two prospectuses behind the home jurisdiction prospectus in those countries that took the longest to approve passported UCITS for sale.[13]

Another drawback to UCITS I was the impractical nature of the regime. Although some of the restrictions were sensible (such as the restriction on investment in precious metals), other restrictions were less so. In particular, rules preventing the holding of cash and money market instruments (other than as ancillary liquid assets) effectively prevented a UCITS cash fund. In addition, there was no provision for a UCITS fund of funds.

The amending directives

The Management Directive

The Management Directive aimed to give more flexibility to the management companies that provided services to UCITS. Under UCITS I, management companies were limited to the management of unit trusts and investment companies.[14] The Management Directive expanded the services that a management company could provide to include the provision of investment management services to UCITS, investment funds other than UCITS, and investment portfolios, including those owned by pension funds.

The Management Directive also has permitted Member States to allow management companies to engage in non-core activities such as custodial, administrative, investment advisory and transfer agency services.[15] Management companies are also allowed to passport their authorised services to other Member States by establishing a branch office provided they meet certain conditions.[16]

The Management Directive also allows management companies to delegate certain functions under certain conditions. The management company must provide notice to the relevant Member State regulators and can only delegate to a qualified and capable delegee.[17] In addition, adequate procedures must be in place to allow the management company to effectively monitor the delegee. Furthermore, information relating to any delegated functions must be added to the applicable UCITS prospectuses.[18]

The Management Directive introduced specific capital adequacy standards to ensure the financial stability of management companies. Management companies must possess initial capital in the amount of €125,000 if they manage up to €250m worth of assets. When the value of the management company's assets under management exceeds €250m, the management company must provide an additional amount of its own funds as capital, equal to 0.02% of the amount of the excess.[19]

Member States were also required to develop rules to ensure that those who run management companies possess the appropriate skills and character to provide investment advisory services.[20] As part of this requirement, management companies must disclose certain information about those who own or manage the business to home Member State regulators.

Each Member State must also enact prudential rules for management companies (or the investment fund itself, if managed by its board), requiring, among other things, sound procedures for administration, accounting, record keeping, internal controls, and data processing as well as the management of any conflicts of interest that may arise between the management company and its clients.[21]

The Management Directive also facilitated operations by introducing a "simplified prospectus" in marketing UCITS. The simplified prospectus provides investors with more user-friendly information describing the investments and general information about the fund. The full prospectus must still be made available to prospective and current investors free of charge upon request.[22]

The Product Directive

The Product Directive increased the appeal of UCITS to investors by allowing fund managers to employ more diverse strategies, including the use of index tracking or creation of a "fund of funds." Furthermore, the Product Directive clarified the definition of "transferable securities," although the definition is being examined for further possible revision. The term "transferable securities" now includes: "shares in companies and other securities equivalent to shares in companies (shares), bonds and other forms of securitised debt (debt securities), [and] any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange, excluding the techniques and instruments referred to in Article 21 [i.e., derivatives]."[23] Thus, derivatives have been expressly excluded from the definition of "transferable securities."

The Product Directive prohibits short sales, as did the original directive. Therefore, UCITS must continue to be "long only" ventures and cannot replicate short selling strategies employed by many hedge funds.

Indeed, the Product Directive expanded the range of permissible investments, which had a positive impact on many types of funds, some of which are highlighted below.

Money market funds

The Product Directive made it possible for companies to offer money market funds in UCITS form by permitting investment in "money market instruments."[24] Such money market instruments must either be traded on a regular market, as defined by the Investment Services Directive (ISD),[25] or be issued by a regulated issuer and meet certain conditions.[26]

Cash funds

The original directive required that any liquid assets be strictly ancillary in nature.[27] The Product Directive significantly liberalised the original directive by allowing a cash fund[28] to be established. The Product Directive allowed these cash funds to be established by allowing a UCITS to hold, for investment purposes, demand deposits, having no greater than 12 months maturity, in credit institutions that are authorised by a Member State or that are determined by the UCITS' home Member State to be subject to equivalent regulation.[29] However, no more than 20% of the UCITS' assets may be placed with the same institution.[30]

Fund of funds

The Product Directive extended the range of permissible investments to allow a "fund of funds" in UCITS form under certain conditions. A UCITS, for example, may not invest in any fund which invests more than 10% of its assets in other collective vehicles (so called "funds of funds of funds") in order to prevent "pyramiding" or "cascading" structures.[31] In addition, a UCITS may not invest more than 10% (or 20% if so allowed by the Member State) in any single fund, nor may a UCITS acquire more than 25% of the units of any other UCITS.[32] A UCITS may invest in non-UCITS funds, but only if the non-UCITS fund:

- has the sole objective of collective investment of capital raised from the public in transferable securities;
- operates on a risk spreading principle;
- issues units which are redeemable out of the assets of the fund at the request of the unit holder;
- is subject to equivalent supervision and investor protection as a UCITS fund; and
- publishes annual and semi-annual reports.[33]

No more than 30% of a UCITS' assets may be invested, in the aggregate, in non-UCITS funds.[34]

To prevent any potential double-charging which may occur within a fund of funds structure, a UCITS employing such a structure must disclose management fees charged by the underlying funds; if the UCITS invests in funds that are under common management with the UCITS, no subscription or redemption fees may be charged to the UCITS by the underlying fund(s).[35]

Member States will not "look through" to the composition of the portfolio investments of underlying funds to determine the top-level UCITS' compliance with prudential and issuer concentration limits established by the UCITS directives.[36]

Derivative funds

The Product Directive also created the opportunity for a "derivative fund" to be established. While UCITS had always had the power to invest in derivatives for hedging purposes, the Product Directive liberalised a UCITS' ability to use derivative products to achieve its investment objectives.[37] A UCITS investing in derivatives must:

- disclose the nature and purpose of its derivative investments;
- note whether such activity is integral to the fund's investment objectives; and
- discuss the effect of the derivative instruments on the fund's risk profile.[38]

A UCITS may invest in derivatives that are cash settled and that are dealt either on regulated or over-the-counter (OTC) markets.[39]

A UCITS' investment in derivatives must meet specified conditions to ensure that counterparty risk is minimised and that the derivatives themselves are sufficiently liquid.[40] Instruments underlying derivatives must be assets in which the UCITS would otherwise be permitted to invest directly. The Member State regulator must also ensure that counterparties to OTC derivative transactions must be subject to proper supervision and regulation and must be capable of daily valuation and fair value liquidation.[41] In OTC derivative transactions, exposure to any single counterparty must be limited to 5% of a UCITS' assets.[42]

A UCITS seeking to invest in derivative instruments must establish sound risk management procedures to monitor and evaluate risk both on a position-by-position basis and for the portfolio as a whole.[43] "Embedded" derivatives (i.e., derivative components of transferable or money market securities) must also be taken into account for risk management purposes.[44] A UCITS' global exposure to derivatives may not exceed its total net portfolio value.[45]

Tracker funds

The Product Directive also made it possible to establish "index" or "tracker" UCITS, which track a financial index (e.g., the S&P 500 or the FTSE). The index must be one that is recognised by home Member State authorities.[46] A UCITS that operates as a "tracker" fund must disclose in its prospectus that it tracks a particular index. The Product Directive provides that where the objective of the UCITS is to track such an index, issuer concentration limits could be raised to 20%.[47]

The future of UCITS

UCITS III improved and modernised the UCITS regime by expanding the range of permissible investments and giving more flexibility to management companies. However, additional changes are still needed for UCITS to keep up with the range of sophisticated products across Europe and the UK.

One step toward this goal was the Commission's Green Paper which proposed measures to cut costs and enhance the efficiency of the European fund industry. The Green Paper reviews the operation of the overall legislative framework for investment funds under the UCITS Directive. The Commission's proposals are based on extensive research and analysis drawn from extensive consultation from the industry and national authorities.

The central message of the Green Paper is that there is no compelling case at this stage for legislative overhaul. Instead, the Commission presents short-term measures to improve the implementation and efficient operation of existing rules. These short-term measures include eliminating the uncertainty surrounding the recognition of funds launched during the transition from UCITS I to UCITS III; simplifying notification procedures for passporting funds across Member States; implementing the Commission's recommendations on the use of derivatives and the simplified prospectus; and clarifying the definition of eligible assets which can be acquired by UCITS.[48]

To assist the Commission in some of these short-term measures, the Committee of European Securities Regulators (CESR), which was established in part to serve as an advisory group to assist the Commission in the field of securities,[49] has published two consultation papers to the Commission on clarification of definitions concerning eligible assets for investments of UCITS.[50] CESR hopes to further develop its draft advice based on industry responses with the goal of providing greater freedom for UCITS products.

CESR's recommendations include: clarifying the position on instrument liquidity and providing guidance in determining whether a particular security is sufficiently liquid for the portfolio; permitting UCITS to invest in closed-end real-estate funds and private equity funds subject to appropriate investor protection; and allowing investment in derivatives on financial indices based on non-eligible assets (such as commodities, real estate, hedge funds, or other assets) under certain conditions. CESR will present its conclusions to the Commission in mid-January 2006 after it has carefully considered all comments from the industry.

In addition, CESR published its first consultation paper on draft guidelines concerning the cross-border notification procedure of UCITS.[51] CESR is working to develop common guidelines to streamline and simplify the notification process to sell UCITS across EU borders. The consultation paper describes concrete proposals for a common approach to the notification and implementation by Member States of the notification procedures set forth in the UCITS Directive. CESR hopes to present its findings to the Commission in mid-January 2006.

Conclusion

The goal of a creating an environment in which UCITS can be passported effectively across a single market is making progress. The Commission and CESR are working together to deliver consistent implementation of UCITS law. The Commission's issuance of its Green Paper, and CESR's publication of its consultation papers to help shape some of the Commission's recommendations, continue to move the EU in the right direction toward this goal. The Commission and CESR are actively working towards addressing key issues that affect market participants, such as:

- dismantling national differences;
- simplifying notification procedures in Member States;
- establishing common enforcement practices;
- boosting transparency among UCITS products;
- keeping up with developments in the European investment industry; and
- keeping shareholder interests at the forefront of legislation.[52]

Addressing these issues will be important in the years ahead, as UCITS is predicted to become the vehicle of choice for not only private retirement planning but pension plans too. UCITS are a natural vehicle for retirement savings, according to Charlie McCreevy, the European Union's internal markets commissioner. The industry must explore ways in which UCITS could be developed and packaged to meet this market demand and to increase its share in the European fund marketplace. The European Commission must therefore develop rules that are flexible enough to keep up with financial innovation in order to become a modern European model for securities legislation.

Notes:

[*] Dechert LLP is not responsible for the contents of this article, which should not be considered a legal opinion on specific facts or a substitute for legal advice.

[1] Green Paper on the Enhancement of the EU Framework for Investment Funds (COM (2005) 314) (July 12, 2005).

[2] Id.

[3] The EU, formerly known as the European Community, consists of the following countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom, and as of April 30, 2004, Cyprus (Greek part), the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.

[4] Directive 85/611/EEC, OJ No. L 375, 31.12.1985, at 3, as amended by Directive 88/220/EEC, OJ No. L 100, 19.4.1988, at 31.

[5] Directive 2001/107/EC, OJ No. L 41, 13.2.2002 at 20.

[6] Directive 2001/108/EC, OJ No. L 41, 13.2.2002 at 35.

[7] See supra Note 1.

[8] See UCITS I, Art. 1(2).

[9] Under UCITS I, each Member State was able to enact its own regulatory and advertising regimes for marketing of a UCITS. As a result, each UCITS must comply with the different regulatory regimes of each Member State in which it sells units.

[10] UCITS I, Art. 19(2)(b).

[11] UCITS I, Art. 36. A Member State could authorise UCITS to borrow up to a limit of 10% of its value (15% where the borrowing was undertaken to acquire real property) on a short term basis. Id.

[12] A Harmonised, Simplified Approach to UCITS Registration (April 2005) by the European Fund and Asset Management Association and Investment Management Association, pg. 15-20.

[13] Id.

[14] Original Directive, supra note 3, Article 6.

[15] Management Directive, supra note 3, Art. 1, amending Article 5 of the UCITS Directive.

[16] Management Directive, supra note 3, adding Article 6a to the UCITS Directive.

[17] Art. 5h(1), as added by the Management Directive, Art. 1(3).

[18] Management Directive, supra note 3, Art. 1, amending Art. 28 of the UCITS Directive.

[19] Management Directive, supra note 3, adding Article 5a to the UCITS Directive. In no circumstances, however, shall the aggregate amount of the required initial capital and the amount contributed by the management company exceed €10,000,000.

[20] Art. 5a & 5b, as amended by the Management Directive, Art. 1(3).

[21] Art. 5d & 5f, as amended by the Management Directive, Art. 1(3).

[22] Art. 33, as amended by the Management Directive, Art. 1(13).

[23] Art. 1(8), as added by the Product Directive, Art. 1(2).

[24] The Product Directive defines "money market instruments" as those "which [are] normally dealt in on the money market, which are liquid and have a value which can be accurately determined at any time." See Art. 1(9), as added by the Product Directive, Art. 1(2). Included within this definition

would be T-Bills and certificates of deposit.

[25] Council Directive 93/22/EEC, 1993 O.J. (L 141) 27.

[26] The money market instrument must be: (i) issued or guaranteed by specified issuers, including governmental authorities of a Member State (or some sub-division thereof) or specified non-governmental institutions; (ii) issued by an undertaking whose securities are dealt on a regulated market; (iii) issued or guaranteed by an establishment subject to regulation at least as stringent as [the EU] (or regulated by the [EU]); and (iv) issued by an issuer the category of which is approved by the UCITS' home Member State regulator and which is subject to certain additional conditions as described by Article 19(1)(h). See Art. 19(1)(h), as added by the Product Directive, Art. 1(5). Such conditions appear designed to ensure the financial health of the issuer and the solvency of the instrument.

[27] UCITS I, Art. 19(4). In recitals 8 and 9, the Product Directive distinguishes between bank deposits held for investment under the UCITS' charter (i.e., as part of its investment strategy) and ancillary liquid assets which would be used to cover payments, facilitate reinvestment of proceeds from the sale of portfolio holdings or where market conditions require suspension of investment in other financial assets.

[28] Cash funds seek to provide maximum safety and liquidity while offering current income principally by investing in high quality, short-term instruments (e.g. bank deposits).

[29] Art. 19(1)(f), as added by the Product Directive, Art. 1(5).

[30] Art. 22, as amended by the Product Directive, Art. 1(10).

[31] Art. 24, as amended by the Product Directive, Art. 1(13).

[32] Art. 24, as amended by the Product Directive, Art. 1(13)

[33] Art. 19(1)(e), as added by the Product Directive, Art. 1(5).

[34] Art. 24(2), as amended by the Product Directive, Art. 1(13).

[35] Id.

[36] Id.

[37] Art. 19(1)(g), as added by the Product Directive, Art. 1(5).

[38] Art. 24a, as added by the Product Directive, Art. 1(14).

[39] Art. 19(1)(g), as added by the Product Directive, Art. 1(5).

[40] Id.

[41] Id.

[42] Art. 22, as amended by the Product Directive, Art. 1(10). This limit is raised to 10% where the counterparty is a credit institution in which the UCITS would be permitted to place deposits. However, the aggregate exposure to any one counterparty may not exceed 20% of a UCITS' assets.

[43] Art. 21, as amended by the Product Directive, Art. 1(9).

[44] Art. 21(3), as amended by the Product Directive, Art. 1(9).

[45] Art. 22, as amended by the Product Directive, Art. 1(10).

[46] These indicies must: (i) have "sufficiently diversified" compositions; (ii) represent an "adequate benchmark" for the referenced market; and (iii) be published in an "appropriate manner."

[47] Art. 22a(1), as added by the Product Directive, Art. 1(11). In some extraordinary cases, concentration of up to 35% may be allowed. Art. 22a(2), as added by the Product Directive, Art. 1(11).

[48] See supra note 1, at pg. 4.

[49] Directive 2001/527/EC, OJ No. L 191/43, 13.7.2001.

[50] Ref. CESR/05-619, October 20, 2005 and See Ref. CESR/05-064b, see also the press release Ref. CESR/05-172).

[51] Ref. CESR/05-484, October 27, 2005.

[52] See supra note 1 at pg. 4, 11.

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