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UCITS IV: Reforms to the UCITS Directive Adopted by the European Parliament

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UCITS IV: reforms to the UCITS Directive adopted by the European Parliament

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On January 13, 2009, the European Parliament approved significant changes to the UCITS Directive ('UCITS IV').[2] The changes, which are scheduled to come into effect in July 2011, will bring much anticipated reform to the €5 trillion European retail investment funds market.

In summary, the European Parliament has approved the following changes:

1. Provision for a management company passport, which will allow management companies authorised in one EU member state ('Member State') to manage funds structured as undertakings for collective investment in transferable securities ('UCITS') domiciled in any Member State. This will allow centralised management of funds by asset managers, which should lead to reduced costs.
2. Overhaul of the cross-border registration notification process, which should greatly shorten the time required to register a UCITS in another Member State and decrease costs of cross-border registration.
3. Provision for standardised requirements for cross-border mergers, which should allow UCITS to merge more easily, thus reducing costs of mergers.
4. Provision for the use of master-feeder UCITS funds.
5. Replacement of the Simplified Prospectus with a 'Key Investor Information' document designed to provide information to investors in a standardised format, allowing greater knowledge by investors prior to investment in a fund.

These provisions are discussed in detail below.

Background

The European investment funds industry has grown to be a major player in capital markets. The most common investment fund in Europe is the UCITS fund, which accounts for approximately 75% of assets under management in the fund industry in Europe[3] and a growing percentage of assets under management in the fund industry worldwide.

The UCITS Directive was first 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'). The aim of the UCITS Directive was to establish a product known for investor protection, through strict investment limits, capital and disclosure requirements, and independent oversight procedures.

The UCITS Directive has been key to the successful development of the European market for investment funds. However, critics observe that improvements are necessary both to make existing provisions of the UCITS Directive more effective and to add new, much-needed, provisions to the Directive. The procedure to market UCITS across Member States is long and bureaucratic, and investors have little means by which to make a comparative assessment of proposed investments. As a result, many UCITS are not registered across multiple Member States; many separate, smaller funds are created in separate jurisdictions, and the cost of managing those funds remains high. Ultimately, those costs are passed on to investors. Critics also observe that UCITS are facing increasing competition from other, more innovative products in the European market, so reforms to the UCITS Directive are necessary to ensure competitiveness of UCITS in comparison to other products.

Changes approved by the European Parliament

The European Parliament approved the following changes on January 13, 2009:

The Management Company Passport

The management company passport provisions were the most controversial of the UCITS IV changes. When the European Commission originally proposed the UCITS IV changes to the European Parliament, they excluded the management company passport provisions because of concerns raised by several Member States. The European Commission asked the Committee of European Securities Regulators ('CESR') to advise the European Commission on issues arising in connection with the management company passport by November 1, 2008.[7] CESR's response was then considered by the European Commission and UCITS IV included the proposal for the management company passport.

Under UCITS IV, management companies authorised in one Member State would be permitted to offer any services they are authorised to provide in that Member State (the 'home Member State') throughout the European Union, including distribution of UCITS (either those it manages or UCITS managed by other management companies) and the management of UCITS domiciled in other Member States. A UCITS would no longer be required to have a management company domiciled in the same jurisdiction as the UCITS. Under the UCITS IV provisions, a management company located in, for example, the UK, would be required to comply with UK requirements with respect to its organisation, including risk management procedures, prudential rules, and supervision. If that management company served as a management company to a UCITS domiciled in, for example, Ireland, the management company would need to comply with Irish requirements for the constitution and functioning of the UCITS, including the set up of the UCITS, establishment of investment policies and restrictions, valuation of assets and accounting for the UCITS, and marketing requirements. The depositary of a UCITS with a management company regulated in another Member State would be required to enter into an information sharing agreement with the management company in order to ensure that the depositary has access to all information necessary for it to fulfil its responsibilities.

CESR noted in its advice that five Member States (Ireland, Luxembourg, Poland, Slovakia and Slovenia) dissented from the proposal to allow the management company passport. The dissenters argued that having the management company and the UCITS supervised by different regulators would result in an unsound supervisory structure which would not allow the regulatory authority of the UCITS to perform its duties effectively. In particular, the dissenters believed that the division of responsibility between the home Member State regulator of the management company and the home Member State regulator of the UCITS was not realistic. In addition, the dissenters were concerned that this arrangement would result in decreased investor protection, and that more substantive regulation is necessary to protect the UCITS brand.

Many of the provisions of UCITS IV call for the European Commission to adopt subsequent measures in order to implement the changes, including, with respect to implementation of the management company passport, guidance on organisational requirements, risk management, and conflicts of interest. It is likely that this process will be time-consuming and subject to dissent by various Member States.

Simplified Notification Procedure

Currently, the process for a UCITS to 'passport' into another Member State can be time-consuming and expensive. The Member States into which a UCITS is passported (the 'host Member States') often require UCITS to translate fund documentation (the prospectus, simplified prospectus, annual report, semi-annual report and often the fund's constitutional documents) into the local language of the host Member State. The translations can be expensive and can take several weeks to prepare. Once the documentation is translated, the UCITS must submit the documentation, together with a certificate/attestation from its home Member State regulator, to the regulator of the host Member State. The host Member State regulator then has a period, which can be as long as two months, to review the documentation. The host Member State regulator also has the right to ask questions of the UCITS and toll the two month waiting period while discussing questions with the UCITS. Finally, regulators in a number of host Member States also frequently request supplemental documentation to be submitted, such as supplements to the prospectus containing disclosure relevant to investors in the host Member State (including local tax information and contact information for local representatives), country-specific application forms (such as the Extended Application Form required in Italy), and supplemental disclosure of risks (such as the French Addendum). The cross-border registration process can take three to six months to complete and, when compared to the ability of non-UCITS products to be brought to market, UCITS can compare unfavourably.

Under UCITS IV, a UCITS that would like to register in another Member State would file a notification letter with its home state regulator containing information on how the UCITS proposes to market its shares in the intended host Member State. Along with the notification, the UCITS would be required to submit to its home Member State regulator its constitutional documents, prospectus and, where appropriate, latest annual and semi-annual report. The UCITS would also have to submit the new 'Key Investor Information' document (described below), translated if required.

From the time the notification letter and accompanying documents are received by the home Member State regulator, that regulator would have a period of 10 days to transmit the complete documentation along with a UCITS attestation or certificate to the host Member State. Once all documentation has been sent by the home Member State to the host Member State, the UCITS would be able to start marketing its shares/units in the host Member State. Therefore, the current two-month waiting period for review by the host state regulator would be eliminated.

Under UCITS IV, a host Member State would not be allowed to impose any additional requirements or administrative procedures on the passported UCITS or request any additional documentation prior to its authorisation to be marketed in the host Member State. Therefore, a host Member State would be unable to block or condition any cross-border registration. The host Member State could regulate distribution arrangements and marketing arrangements, including marketing materials, but this could not interfere with the UCITS' right to access the market once the notification has been made. These provisions may be difficult to implement in practice, and it will be necessary to monitor how different Member States implement these requirements.

In order to further simplify the notification procedure, UCITS IV introduces new translation provisions for UCITS documentation. UCITS documentation other than the Key Investor Information (such as the prospectus, annual report, semi-annual report, etc.) could be translated into (i) a language customary in international business (such as English) or (ii) the local language of, or other language approved by, the home Member State. The choice of language would be left to the UCITS under UCITS IV. Only the Key Investor Information would be required to be translated into the language required by the host Member State when passporting a UCITS. The translation of documents other than the Key Investor Information will therefore be a market-driven decision.

New rule on mergers

UCITS, on average, are one-fifth the size of US mutual funds, and the cost of managing them is twice as high. Although it would be beneficial to consolidate these funds if possible, there currently are many legislative and administrative difficulties to merging UCITS on a cross-border basis.

UCITS IV implements simplified provisions for cross-border mergers of UCITS, with the goal of allowing asset managers to pool assets to create more efficient funds. Under UCITS IV, before a merger can take place, the merging UCITS must submit to its home Member State regulator information including (i) the terms of merger duly approved by both the merging UCITS and the receiving UCITS,[8] (ii) confirmation from the depositaries of the merging UCITS and the receiving UCITS that they have verified the compliance of the terms of the merger with UCITS IV and the constitutional documents of the UCITS; and (iii) communications to be provided to investors in both the merging UCITS and the receiving UCITS. The UCITS IV Directive lays out detailed timetables for both the home Member State regulator of the merging UCITS and the home Member State regulator of the receiving UCITS to review and comment on the materials and approve the merger. The costs of the merger must be borne by the management company or promoter, and not by the UCITS.

UCITS IV requires that an independent auditor must validate the criteria used for valuing the assets and liabilities of the UCITS involved in the merger and for calculating the exchange ratio. Additionally, UCITS IV allows for the national laws of Member States to determine whether shareholder approval is required. If shareholder approval is required, UCITS IV requires Member States to ensure that approval must be obtained, at a maximum, by 75% of the votes of shareholders present or represented at the shareholders meeting. It may be necessary for certain Member States to change their laws on voting requirements to comply with these voting requirements. Finally, UCITS IV requires both the merging UCITS and the receiving UCITS to allow shareholders to redeem or exchange shares free of charge prior to the merger.

It is hoped that the implementation of these standardised cross-border merger requirements for UCITS will result in less onerous filings with regulators of both the merging UCITS and the receiving UCITS, a simplified and more efficient (and therefore less costly) process for mergers, and less delay in the merger process. In practice, however, this process requires close cooperation between regulators, and may be difficult to implement.

New rules on a master-feeder structure

As noted above, there currently are many small UCITS funds in Europe. It is the cultural preference in a number of jurisdictions for investors to invest in a domestic, rather than a non-domestic, fund. Because the UCITS Directive currently does not allow the use of master-feeder structures, it is difficult to pool those assets to create larger, more cost-efficient funds.

UCITS IV will permit the use of master-feeder structures, and provides for the conversion of existing UCITS into UCITS feeder funds. This would allow smaller funds in several jurisdictions to invest their assets into one master UCITS, with the goal of achieving economies of scale. Under UCITS IV, a feeder UCITS would be required to invest at least 85% of its assets into the master UCITS; the remaining 15% could be invested in other liquid instruments and financial derivative instruments (for hedging purpose only). A master UCITS could not itself be a feeder UCITS or hold shares of another feeder UCITS.

The specific investment policy of a feeder UCITS would need to be approved by the feeder UCITS' home Member State. In addition, the feeder UCITS and the master UCITS would be required to enter into an agreement, under which the master UCITS must agree to provide the feeder UCITS with all information and documentation necessary for the feeder UCITS to ensure it is in compliance with the UCITS Directive. In the instance that the master UCITS and feeder UCITS are managed by the same management company, it would be sufficient for the management company to implement internal conduct of business rules rather than enter into an agreement. In the event that the master UCITS and feeder UCITS have different depositaries or and/or auditors, it would also be necessary for the two depositaries or the two auditors to enter into information sharing agreements to ensure that the feeder UCITS' depositary and auditor are able to fulfil their responsibilities.

'Key Investor Information' document

Currently, a UCITS is required to offer investors and potential investors a 'simplified prospectus'. In practice, the simplified prospectus has been criticised because it is often too lengthy.

Under UCITS IV, the simplified prospectus will be replaced by a new 'Key Investor Information' ('KII') document. The KII is meant to provide information about the essential characteristics of the proposed investment in a clear manner likely to be understood by retail investors. The KII will be required to be given to investors in good time before purchase of a UCITS in order to allow investors to reach an informed investment decision.

The KII will be required to be written in a concise manner, in non-technical language and include the following:

- a short description of the investment objective and investment policy;
- past performance or, where relevant, performance scenarios;
- costs and associated charges; and
- risk/reward profile of the investment, including guidance on and warnings of the risks associated with investments in the UCITS.

UCITS IV also gives the European Commission the ability to adopt implementing measures on the details of the content of the KII, as well as additional information in situations where the UCITS is structured as an umbrella fund, a fund of funds, a master/feeder, an exchange-traded UCITS or structured, capital protected or other type of UCITS.

Future steps

UCITS IV was approved by the European Parliament on January 13, 2009. Although the changes still need to be approved by the European Council, this approval is believed to be likely. The European Parliament has called on the European Commission to adopt detailed measures on a number of concepts necessary in order to implement UCITS IV. Furthermore, Member States will need to consider implementing changes in their national laws in order to implement UCITS IV by July 1, 2011.

UCITS IV has the potential for many benefits. It is hoped that the management company passport provisions, the cross-border merger, and master-feeder arrangements, and the simplified cross-border notification provisions will result in a simpler cross-border regulatory environment, greater economies of scale for many UCITS, and the ability to pool assets and reduce costs. However, a great deal of work remains in order to implement the UCITS IV provisions, both at the European Commission level and within each Member State. Asset managers should keep in mind now how these changes might impact their business plans and provide opportunities going forward.

Notes:

1 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.

2 European Parliament legislative resolution of January 13, 2009 on the proposal for a directive of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)(recast)(COM(2008)0458-C6-0287/2008-2008/0153(COD)).

3 The €5.1 trillion UCITS industry represents 75.7% of the European fund market. See EFAMA Quarterly Statistics Release No. 35 (Third Quarter of 2008), European Fund and Asset Management Association.

4 Directive 85/611/EEC, OJ No. L 375, 31.12.1985, at 3, as amended by Directive 88/220/EEC, OJ No. L100, 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 Letter from Eddy Wymeersch, *Committee of European Securities Regulators*, to Charles McCreevy, *European Commission* (Oct. 31, 2008).

8 The terms of merger must include the following: (i) the background to and the rationale for the proposed merger; (ii) the expected impact of the proposed merger on shareholders of both the merging UCITS and receiving UCITS; (iii) the criteria adopted for valuation of assets and, where applicable, the liabilities on the planned effective date of the merger; (iv) the calculation method of the exchange ratio; and (v) the rules applicable to the transfer of assets and exchange of shares. Regulators cannot require that any additional information must be included in the terms of the merger.

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