UCITS Funds – Global Opportunities For Promoters and Investors

The worldwide financial crisis has severely affected the international investment funds sector and exposed a number of inherent weaknesses in fund structures, strategies and operations. In particular, failings in risk management and due diligence processes were highlighted, along with substantial leverage, liquidity and counterparty risks. As an asset class, so-called "absolute return" and other hedge funds were especially hard hit,[1] with assets under management shrinking substantially due both to trading losses and investor redemptions, with managers often compelled to invoke redemption "gates" to stem the haemorrhaging and avert an unwinding of the fund. In addition, the revelation of massive frauds, such as the Madoff scandal, led to widespread calls both within and outside the funds industry for heightened regulation and enhanced transparency, while also triggering a global debate regarding the systemic risks posed by investment funds to the world's markets.

These and other developments have led a number of leading fund promoters to transition from private fund platforms to the European Union ("EU") regulatory regime for so-called Undertakings for Collective Investment in Transferable Securities ("UCITS"). The UCITS "brand" has become recognized worldwide as an efficient and flexible investment product, affording significant investor protections to a broad pool of potential investors, including retail investors, while still permitting managers sufficient investment latitude to pursue high return strategies.

The migration to UCITS funds has additionally been boosted by two trends witnessed in recent years within the sector: the global proliferation of the marketing and sales of UCITS beyond EU borders, and the increasing sophistication of the UCITS regulatory framework and its responsiveness to market demands.

Background

Introduced in 1985, the principal objective of the UCITS Directive[2] is to harmonize domestic EU retail markets for cross-border open-ended collective investment schemes. The regime allows the "passporting" of UCITS funds throughout the EU which creates the ability to market UCITS across the EU subject only to compliance, in each host state, with the notification procedures laid out in the UCITS Directive while simultaneously ensuring a high level of investor protection.

The UCITS Directive sets forth the general requirements for the organisation, management and oversight of UCITS funds and defines the parameters for, among other things, fund investment, leverage, diversification, portfolio liquidity, audits, asset custody, prospectus disclosure and engagement of service providers. The 2001 amendments to the Directive (UCITS III) significantly broadened the range of investments (so-called "eligible assets") in which UCITS funds can invest, including rather complex instruments such as derivatives, allowing

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[1] Estimates suggest that during the second half of 2008 alone, global hedge fund assets had fallen by 32.3% to an aggregate of $1.8 trillion. In addition, the number of hedge fund liquidations continues to outpace the number of launches, with 292 liquidating during the second quarter of 2009 (and 668 liquidating during the first half of 2009), compared to 182 new funds launches during the same period (sources: HedgeFund Intelligence; InvestmentNews).

[2] The UCITS Directive is the legislative instrument adopted by the European Parliament and the Council of the EU constituting the UCITS regulatory regime and currently consists of Directive 85/611/EEC of 20 December 1985 (UCITS I) amended, *inter alia*, by Directives 2001/107/EC and 2001/108/EC of 21 January 2002, together also known as the UCITS III Directive.

fund managers to partially deploy alternative fund-type strategies within the long-only UCITS space. Notwithstanding the expansion of eligible assets, there remain certain liquidity requirements and constraints on the use of leverage under the UCITS Directive that may constitute substantial hurdles, if not barriers to entry, to certain managers which will, therefore, likely remain outside the scope of the UCITS brand.

The Global Reach

The EU's UCITS framework has been largely successful,[3] and the UCITS brand's recognition has rapidly evolved into a benchmark for international excellence. Coupled with the flexibility added by UCITS III, this "gold standard" has generated widespread investment appetite among sophisticated investors worldwide and propelled UCITS global sales, particularly within Asia, South America and the Middle East, where investors and regulators are becoming more and more comfortable with UCITS' built-in safeguards. In fact, non-EU sales have accounted for approximately 40% of aggregate UCITS sales in recent years.

Within Asia, the main markets for UCITS have been Hong Kong, Singapore and Taiwan, in which UCITS account for more than 70% of all authorized funds' sales[4] due to a lack of regulatory and/or tax barriers to entry and strong regulatory acceptance. This regulatory confidence is critical to the success of the UCITS structure cross-border. Taiwan and Singapore are prime examples of the trust local regulators put into the EU UCITS supervision procedures, as they only demand a simple notification process for the registration of UCITS in their local market. Elsewhere, Chile and Peru have been prominent distribution channels for UCITS in South America, while Bahrain and South Africa rank highest in the Middle East and Africa respectively.

The globalization of UCITS has delivered benefits not only to a diverse range of investors, but also to a wide range of managers, enabling them to develop a single, flagship investment product with global reach, thereby reducing product replication costs and generating considerable economies of scale. Further, the attraction of both retail and institutional clients from diverse geographical, regulatory and fiscal settings has prompted managers to rapid innovation and product development and increased their cross-border business expertise.

In addition, the UCITS Directive requirement regarding the separation of fund functions has allowed managers to focus on their strengths and core competence of portfolio management, while forming alliances with third-party service providers to ensure robust support services. Large global firms use the UCITS framework to complement their product suite, often mirroring to a certain degree the strategies pursued by their non-UCITS funds. By contrast, newly formed managers use the UCITS brand to penetrate new markets and extend their firms' global reach.

For investors, UCITS offer choice, service and value for the money. Investors can choose from a broad range of investment strategies produced by reputable managers with a good track record of return, underpinned by full transparency and backed by strong risk and compliance systems. Investors further benefit from a solid support structure run by trusted third-party administrators ensuring a high level of investor protection.

Fund promoters should be aware that along with the substantial benefits of global UCITS distribution come important challenges. Managers' expansion of marketing efforts beyond EU borders requires the implementation

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[3] UCITS funds currently have approximately €4.5 trillion under management. Net inflows amounted to €22 billion in the first quarter of 2009 (Source: EFAMA, Quarterly Statistical Release 2009 May).

[4] PwC, Trends in Cross-Border Fund Distribution, available at: http://www.pwc.com/en_LU/lu/podcast/docs/pwc-podnotes-funddistribution.pdf.

of global risk management, legal compliance and product development processes. In addition, in each country of distribution UCITS need to abide by the local regulatory (usually registration with the local regulatory authority), marketing, accounting and tax requirements. Further, these requirements can change regularly, and ongoing management, monitoring and coordination are crucial to avoid the risk of non-compliance. However, the regulatory approval process outside the EU can, in certain cases, be considerably facilitated by the local regulators' familiarity with the UCITS brand, as above illustrated by the Singapore and Taiwan examples. Finally, forming and operating a fund in compliance with the UCITS Directive involves considerable costs. Although it is expected that these costs will be substantially reduced with the introduction of UCITS IV (see below), it is likely they will remain comparably high in relation to non-authorized funds.

UCITS IV

Looking ahead, the global investment appeal of the UCITS product is expected to broaden even further with the advent of the UCITS IV Directive (adopted by the European Parliament on January 13, 2009 and by the EU Council on June 22, 2009), expected to come into force via transposition into national law in each EU Member State no later than July 2011. The most advantageous prescriptions of UCITS IV are generally perceived as removing red-tape barriers to cross-border sales, simplifying the authority notification procedure, particularly with regards to documentation, permitting master-feeder structures and simplifying the procedures relating to cross-border UCITS fund mergers. For these and other reasons, the implementation of UCITS IV is likely to encourage increased investor accessibility through master-feeder structures, reduce operating and administrative costs and broaden the UCITS market.

Conclusions

In sum, the UCITS brand has moved far beyond the original aim of ensuring a robust framework for the marketing of retail investment funds across the EU to become one of the premier global investment products of choice. UCITS IV, moreover, is expected to significantly enhance the trend of UCITS global sales, as well as the product and investment flexibility currently afforded under UCITS III.

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