

UCITS 4 – The Reality of Execution

JUNE 2010

UCITS 4 is a real opportunity for fund groups in Europe to re-consider their business model and strategy. The original UCITS Directive has achieved great things during the 25 years since implementation. Not only are UCITS able to access EU markets, but the construct is regarded by regulators around the world as a solid and reputable one that is designed with the interests of the retail investor in mind. This regulatory framework, and acceptance by international regulators, makes UCITS a successful global brand in terms of distribution, in particular to the developing world.

TABLE OF CONTENTS

UCITS 4 – The Reality of Execution	1
Management Company Passport	2
Registration	
Notification procedures	2
Publish requirements	2
Client transparency – a critical success factor	3
A merger framework	3
Master feeder arrangements	3
Depositary and the future – industry involvement	3
How will the success of UCITS 4 be measured?	4
Contact Information	4

This document has been prepared for J.P. Morgan's clients for informational purposes only and is subject to change. It is not intended to provide, and should not be relied on for, accounting, investment, tax or legal advice. J.P. Morgan clients should consult their own accountants, lawyers or other experts for specific advice.

Global Mutual Fund Business – signalling recovery and positive growth opportunities



Source: Lipper FMI

It is clear that Europe and Asia have much room for consolidation of funds. UCITS 4 will enable groups to consolidate their activities where appropriate and where possible with a view to achieving the economies of scale that the European industry needs to continue to be competitive.

This enabling legislation has at the heart of its drafting – efficiency and scale, with European credentials of openness and shared markets. These lofty ideals may become less relevant in light of today's environment. However, there are opportunities for asset managers who chose to take them.

In this paper, we will discuss the following critical aspects of the legislation and their practical impact:

- 1) Management Company Passport
- 2) Registration
- 3) Shareholder Information
- 4) Future Legislation

We will also discuss the reality of executing UCITS 4 and how the success will be measured.

Management Company Passport

The provision for a management company passport will enable fund managers to consolidate their asset management, risk management and administration in a single jurisdiction, regardless of the domicile of the funds being managed. The creation of one Management Company could have significant cost benefits for a fund manager. They could make savings on their cost of capital as well as management time and resources. The detailed requirements for management companies to bring them into line with MiFID rules will take some time to work through. It may be that making these changes will be challenging enough for managers without going through a major corporate restructuring at the same time – hence, for many, the management company passport will be deferred.

Our view is that as a result of the following challenges, the full potential of the passport won't be realised. Tax is a complicating factor: different rates of corporation tax and VAT mean that there could be significant advantage to selecting a jurisdiction with favourable rates, but clearly businesses will be cautious given the need of most European

governments to raise taxes over the medium term. Delegation of certain functions outside of home jurisdictions will also complicate the picture.

In the short term, it makes sense to review current corporate structures and organisation to eliminate unnecessary duplication of functions.

The big question is: can the management company passport deliver sufficient economies to make up for any additional costs and to make the effort to re-organise worthwhile in the long run?

Registration

Notification procedures

Successful cross-border distribution requires managers to comply with local marketing requirements but the UCITS 'passport' was supposed to fast-track funds for sale in European markets. Prior to the new provisions of UCITS IV, this was often illusory. Notification came to resemble full-scale authorisation and often host state regulators and set out requirements that made the process cumbersome. UCITS 4 introduces streamlined and improved notification procedures that should significantly reduce costs for cross-border managers. Now, the whole procedure will be shortened with electronic regulator-to-regulator notification. The home state regulator will have ten days to verify the fund's application and will then notify approval to the host state regulator; the fund can begin marketing three days later. This is a substantial improvement and is welcome for an industry focusing on distribution.

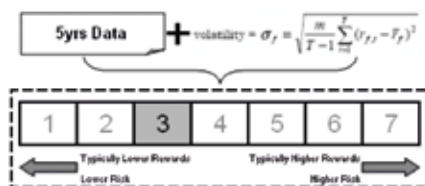
Publish requirements

Alongside this is a new requirement that requires Member States to publish all relevant information on the requirements for marketing of third country UCITS in their territories. The information must be available electronically, be kept up to date and be available in a language customary in the sphere of international finance. This should be very useful for managers with cross-border ambitions that will be able to evaluate this information much more

quickly and cost-effectively than has been the case to date. All in all, the elements of the Directive that focus on fund passporting should save fund management companies significant sums and enable much faster time to market.

Client transparency – a critical success factor

The 'KID', or Key Information Document which takes over from the simplified prospectus, which according to CESR is widely seen as having failed, is exercising many managers at present. Most people agree that a provision of key facts in a standardised fashion, written intelligently in plain language with a view to being understood by investors, is welcome. But there is a fear in the industry that it may be a costly exercise. For example, the KID introduces the SRRI (synthetic risk reward indicator), which must be disclosed for each share class of a UCITS as displayed in the diagram below:



The SRRI is effectively a number calculated with reference to volatility in the unit price over a period of 5 years, which, depending on fund objectives may be based upon a relatively simplistic volatility calculation, or a more complicated 'reverse-engineered' VaR calculation.

The requirement to produce a SRRI will require firms to reconstruct historic data going back over a five year period, which may challenge some accounting systems.

Providing opportunities for fund managers to save money is one thing, but UCITS 4 also seeks to promote efficiency within funds themselves. The arguments for this are well-rehearsed: Europe has too many funds and the number of small uneconomic funds is too great, as a result of which investors may not achieve the returns they could if there were fewer, much larger

funds. UCITS 4's answer to this is two-fold: a merger framework; and master-feeder arrangements.

A merger framework

A harmonised merger framework for UCITS is welcomed by the industry, but few believe this will have a major impact on the number of funds, or on the industry overall. The complexities of taxation, legal and local market requirements as discussed above, makes this a complex and possibly expensive choice. UCITS 4 merger costs would be borne by the manager, and a cost benefit analysis may not give short term positive results. Therefore, we believe widespread fund mergers are not likely.

Master feeder arrangements

What has been attracting most attention is the provision in the new framework for a master feeder arrangement. This is attractive because it offers a means of responding flexibly to a number of distribution issues. For example, a manager that generally launches its products from a cross-border location, such as Luxembourg or Ireland, and would like a similar product in its home domicile but cannot achieve scale domestically, may be able to leverage the scale of its cross-border offering via a master feeder structure.

Similarly, a group with several versions of the same fund in a number of jurisdictions may well be recording varying performance but, perhaps because of local brand or domestic preference, cannot merge into a single efficient unit. A master feeder may provide the opportunity to deliver scale benefits and enhanced as well as consistent performance.

Master feeder also provides the opportunity for white-labelling as an alternative to direct market entry where a local brand, and also in some cases a local vehicle, may be preferred.

However, as always, there is an important challenge to utilising master feeder to its full potential: tax. While in some instances the tax issue is of little or no relevance, in many cases it could be problematic. Tax treaties that provide for either tax

reclaims or reduced withholding tax on fund investments are generally only available in jurisdictions where the vehicle itself is taxed. Hence a UK fund may be able to benefit from reduced withholding tax on income, whereas its Luxembourg equivalent may not be able to do so. Where tax is an issue this is likely to limit the types of funds for which master feeder arrangements will be beneficial. It is vital that professional tax advice is sought in this area.

Our conclusion is that master feeder provides product flexibility and speaks directly to a number of distribution challenges, hence it is likely to have much more practical applicability than mergers.

Depositary and the future – industry involvement

UCITS 4 has not changed the depositary's duty and responsibility for safekeeping of assets, although it is widely assumed that change will emerge following the European Commission's consultation on the UCITS depositary function and the eventual adoption of the Directive on Alternative Investment Fund Managers.

Currently, the duties of a depositary as defined in Article 22 of the recast UCITS Directive are to:

- (a) ensure that the sale, issue, re-purchase, redemption and cancellation of units are carried out in accordance with the applicable national law and the fund rules;
- (b) ensure that the value of units is calculated in accordance with the applicable national law and the fund rules;
- (c) carry out the instructions of the management company, unless they conflict with the applicable national law or the fund rules;
- (d) ensure that in transactions involving a common fund's assets any consideration is remitted to it within the usual time limits;
- (e) ensure that a common fund's income is applied in accordance with the applicable national law and the fund rules.

Under UCITS 4, when a management company is not established in the same Member State as the fund it manages, (and the depositary must be in the Member State domicile of the fund), there must be a written agreement between the management company and the depositary and much of the detail can be contained in a service level agreement. What will be interesting to watch over the next few months is how a depositary's functions and obligations are to be revised, and whether indeed there is any widespread support for the notion of a depositary passport.

It will be very important for the industry to keep abreast of the Commission's proposals when they appear. Every fund will be impacted by these changes.

How will the success of UCITS 4 be measured?

It is clear that the objectives are to make the European fund management business more efficient and to improve investor returns. These ambitions should be achievable, but the scale of enhanced revenues for fund managers and better returns for investors is unknown. Certainly UCITS 4 is a welcome enhancement to the mutual fund business but it is no panacea – the real prize is in diversifying and growing distribution as the developing world opens up to UCITS.

Contact Information

J.P. Morgan Worldwide Securities Services

Ann Doherty
Managing Director
Tel: +44-207-742-0050
ann.doherty@jpmorgan.com

Sheenagh Gordon-Hart
Industry and Client Research Executive, WSS
Tel: +44-207-742-0023
sheenagh.gordon-hart@jpmorgan.com

For more information visit
www.jpmorgan.com/visit/wss