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UCITS III to UCITS IV: A New Era

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This article is the first in a series of publications relating to UCITS and future developments. The purpose of this piece is to provide a high level overview of (i) the historical background to Undertakings for Collective Investment in Transferable Securities (UCITS); (ii) the current position under UCITS III and in particular looking at (a) the Commission of European Securities Regulators (CESR) guidelines concerning eligible assets for investment, and (b) an overview of the options available for traditional hedge funds and fund of funds to now operate within the UCITS framework; and (iii) the proposals relating to UCITS IV due to come into force in July 2011.

Throughout 2009 and, more recently, since the publication of the proposals regarding the draft Alternative Investment Fund Management Directive, there has been a notable uptick in client interest regarding UCITS that has led to numerous asset managers establishing additional UCITS funds, adding UCITS funds for the first time to their portfolio of alternative investment funds or simply investigating and trying to understand the parameters in which a UCITS can invest and be marketed.

UCITS: The Beginning

The objective of the original UCITS directive, adopted in 1985, was to allow for open-ended funds investing in transferable securities to be subject to the same regulation in every Member State within the European Union. Its three main objectives were (i) to keep regulation up to speed with changes in the investment market; (ii) to create a level playing field for funds established in different Member States; and (iii) to ensure investors were well-protected by a single regulator across all markets.

UCITS III: Extending the Investment Scope of UCITS

Following the implementation of UCITS, there were clear signs that the objectives were not being properly satisfied. The marketing rules of various Member States hindered companies wishing to market their products across borders and the definition of "permitted investments" was already becoming redundant in an investment universe demanding innovation, greater returns and more sophisticated products. Finally in 1998, after an aborted attempt to introduce UCITS II, the European Commission published its proposals for UCITS III. This was adopted in 2001 by way of the Directive 2001/107/EC (the "Management Directive") and Directive 2001/108/EC (the "Product Directive") of the European Parliament and of the Council. All Member States were compelled to implement this by February 2007.

The Management Directive sought and continues to seek to give management companies a "European Passport" to operate throughout the European Union, and widens the activities which they are allowed to undertake. It also introduces the concept of a simplified prospectus, which is intended to provide more accessible and comprehensive information in a simplified format to assist the cross-border marketing of UCITS throughout Europe.

The Product Directive in short sought and continues to seek to provide funds the ability to invest in a wider range of financial instruments than was previously the case, e.g., standard long-only funds.

UCITS III funds are currently classified either as “sophisticated” or “non-sophisticated” UCITS funds, depending on the investment powers they choose to adopt. Non-sophisticated funds under UCITS III continue to operate using the same structure as traditional long-only funds, consisting primarily of bonds and equities. Sophisticated funds, however, whilst being able to adopt the vanilla approach outlined above, may also invest in a broader range of asset classes, derivatives and strategies. As part of this investment evolution, it soon became clear that this wider universe of investment powers required guidance from the regulators as to what was permissible within UCITS III. In March 2007, CESR published guidelines relating to eligible assets for investment by UCITS.

Eligible Assets

Eligible assets for UCITS continues to be an evolving platform, and when establishing a fund it is advisable to seek advice as to whether the proposed investment objective and strategy of the fund would in fact be UCITS compliant. The below is intended to be a high-level summary only.

CESR’s guidelines were aimed at removing uncertainty as to whether UCITS can properly invest in the following financial instruments: (i) asset-backed securities; (ii) listed closed-ended funds; (iii) Euro commercial paper; (iv) index-based derivatives; and (v) credit derivatives.

The Directive on eligible assets for UCITS lays down rules clarifying, for the purposes of their uniform application, transferable securities, money market instruments, liquid financial assets connected with financial derivative instruments, transferable securities and money market instruments embedding derivatives, techniques and instruments for the purpose of efficient portfolio management and index-replicating UCITS.

The following may be regarded as key developments in the categorisation of eligible assets for UCITS: (i) closed-end funds are regarded as transferable securities provided that they are subject to certain corporate governance mechanisms; (ii) credit derivatives are regarded as eligible for a UCITS provided that they are in compliance with the criteria applicable to OTC derivatives; (iii) derivatives on a single commodity remain forbidden; and (iv) financial indices, whether or not comprised of eligible assets, can be considered as eligible financial indices once they are sufficiently diversified, represent an adequate benchmark for the market to which they refer and are published in an appropriate manner.

UCITS versus Hedge Funds

UCITS III with its broader investment powers now offers hedge fund managers the ability to use similar strategies and techniques within the UCITS framework, albeit with some important distinctions. Shorting is one of these exceptions. Whereas a hedge fund can short-sell a physical stock or bond, a UCITS III fund is not permitted to do so. However, by investing in a derivative of a particular stock, an asset manager can achieve the same shorting effect. Other major differences include the requirement for a UCITS fund to provide twice monthly liquidity as a minimum as well as its inability to leverage more than 100% through the use of financial derivative instruments.

The appeal of UCITS III products accessing true hedge fund strategy has now spread from the retail to the institutional market which is drawn to high transparency, regulated risk management and improved liquidity offered. With industry projections for 2012 predicting €8,000 billion invested in UCITS products, an increase of 60%, few asset managers can afford to ignore the potential for UCITS products.

UCITS Fund of Funds

Greater numbers of UCITS fund launches and UCITS qualifying hedge funds have also led to a UCITS product base sufficiently diversified to trigger asset managers to establish UCITS fund of funds.

By way of summary, the principle rules relating to UCITS fund of funds are as follows. A UCITS fund may not invest in any fund which invests more than 10% of its assets in other collective vehicles (“funds of funds of funds”) itself in order to prevent “pyramiding” or “cascading” structures. 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 or other fund.

A UCITS may invest in non-UCITS funds, but only if the non-UCITS fund (i) has the sole objective of collective investment of capital raised from the public in transferable securities; (ii) operates on a risk-spreading principle; (iii) issues units which are redeemable out of the assets of the fund at the request of the unit holder; (iv) is subject to equivalent supervision and investor protection as a UCITS fund; and (v) publishes annual and semiannual reports.

In addition, no more than 30% of a UCITS's assets may be invested, in the aggregate, in non-UCITS funds.

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 by the fund of funds UCITS.

UCITS IV

UCITS IV is due to come into force across EU Member States in July 2011.

The principle features of this legislation are:

- Management company passport allowing UCITS authorised in one Member State to be managed remotely by a management company established in another Member State. In practice, currently, a management company can only manage a UCITS where it is domiciled in the same Member State as the fund.
- Simplification of the procedures for cross-border distribution to minimise the ability of Member States to impose their own local registration requirements. Currently, different Member States impose their own local registration requirements which can vary on a country-by-country basis.
- Framework for the domestic and cross-border mergers of UCITS allowing consolidation of UCITS and potential reduction of the Total Expense Ratios of such funds currently passed on to investors.
- Introduction of master-feeder structures to facilitate (mostly tax-driven) asset-pooling.
- Replacement of the simplified prospectus with a key investor information document designed to present comprehensible information similar for the UCITS of each Member State.

Conclusion

The positive aspects of UCITS III and the proposals set out under UCITS IV should be readily apparent. It has opened the doors to European investing in a lower risk regulatory environment and made a wider range of strategies and techniques available to mainstream investors. With some industry experts predicting the hedge fund industry will break up its liquid strategies into UCITS funds and its less liquid strategies into more private equity styled vehicles, now more than ever, UCITS is an investment product not to be ignored as part of the armoury of every fund provider.

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