UCITS IV six months on. Can the Directive deliver on efficiency?

Leading business advisors

Six months have passed since the effective date of UCITS IV on 1 July 2011. Now that the dust has settled, we take a look at the key UCITS IV provisions and how they have fared. Can UCITS IV live up to the high expectations it raised with regard to generating efficiencies?

Overview

Cast your mind back to 2006 and the European Commission's White Paper on "Enhancing the Single Market for Investment Funds", launched amid much fanfare about revitalising the competitiveness of the European fund industry. A Commission study cited how EU funds are on average five times smaller than US funds and the cost of managing them is twice as high.[1] Against this background, UCITS IV aims to tackle inefficiencies by enabling consolidation and economies of scale across Europe, leading to the creation of a genuine Single European Market for investment funds. It was estimated at the time that UCITS IV could save the industry and investors up to €6 billion per year.[2]

The focus of the past six months has necessarily been on implementation rather than on any large-scale strategic decisions under UCITS IV. Mandatory requirements such as the Key Investor Information Document (KIID), organisational rules, conduct of business and VaR model validation and testing have actually increased compliance costs. Yet the streamlined notification process has begun to yield efficiencies for fund promoters launching cross-border funds.

Attention is now gradually shifting back to UCITS IV's key efficiency enhancing provisions as managers consider the strategic and operational implications. Tax complexity and incomplete implementation across the EU are the most obvious hurdles to overcome, while 'natural' obstacles such as national market preferences and existing distribution networks also play a role. Yet opportunities to maximise efficiencies do exist under UCITS IV via the management company passport, master-feeder structures and cross-border mergers. Such projects were always going to require careful consideration and take longer to realise than the first six months of implementation.

UCITS IV risk management

UCITS IV evolved in the aftermath of the financial crisis with a resulting increased focus on risk governance. The Directive requires the appointment of a hierarchically and functionally independent "permanent risk management function" by management companies to review and report regularly on compliance with the risk limits.

ESMA's Guidelines on Risk Measurement and the Calculation of Global Exposure require that a VaR model should undergo independent validation following a) initial development, b) any significant change, c) the need to improve the model based on back testing results. The risk management function must also review the VaR model on an ongoing basis and conduct rigorous stress testing and back testing of the model. Results should be carefully analysed and lead to actions to improve the model where necessary.

Under ESMA's Guidelines each UCITS must document internal risk management measures and limits encompassing market risks, liquidity risks, counterparty risks and operational risks. In short, UCITS IV places a greater emphasis on the documentation of risk policies and procedures as well as the identification, monitoring, reporting, analysing and forecasting of risk.

While UCITS IV has been fully implemented in several EU jurisdictions and policies and procedures have been updated accordingly, management companies, including self-managed investment companies, need to ensure they have the appropriate expertise and resources to implement the risk management policy and demonstrate compliance to regulatory authorities.

1. European Commission press release, "Commission proposes improved EU framework for investment funds", 16 July 2007.
2. European Commission "White Paper on enhancing the Single Market framework for investment funds", COM(2006) 686 final, 15 November 2006.

Simplified notification and regulatory cooperation

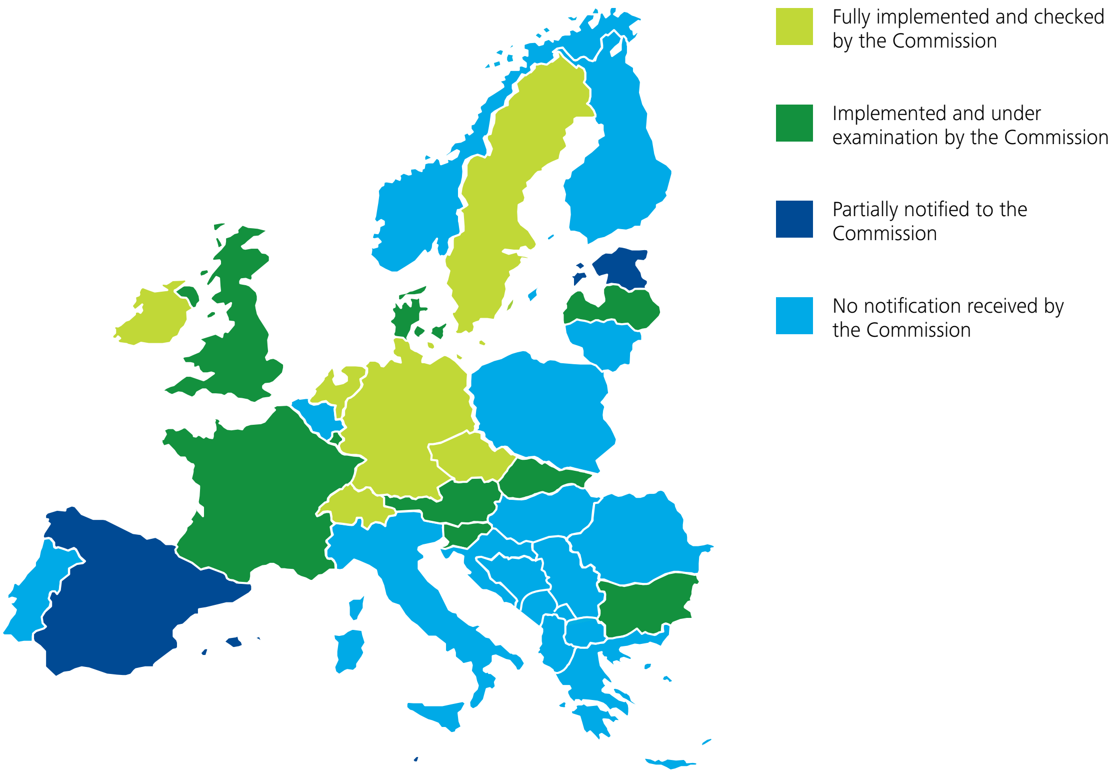
UCITS IV reduced the notification timeframe from two months to ten working days and created a more standardised process for coordination with and between regulatory authorities. Whereas previously the UCITS would submit a notification file to each host member state regulatory authority in which it intended to market, the UCITS home regulator is now responsible for coordinating this process. Furthermore, there is now no obligation to translate documents such as the articles of incorporation, full prospectus and financial report and accounts, which can be provided in a language commonly used in international finance. These are very welcome enhancements which are providing faster access to markets.

While the new notification process has given rise to challenges and confusion as regulators adapt to the new procedures, fund promoters are starting to see the benefits. ESMA has clarified that a host member state authority cannot refuse a valid notification under UCITS IV even if that member state has not transposed the Directive.[3]

The notification process is also likely to become smoother throughout the EU as regulatory authorities become more familiar with the processes and coordinate better with each other.

UCITS IV – current implementation status*

UCITS IV took effect on 1 July 2011 although only a handful of EU member states transposed the Directive into local legislation on time.



*This map has been compiled using information from the European Commission's transposition table as of 15 December 2011 available at http://ec.europa.eu/internal_market/finances/docs/actionplan/index/111205_postfsap_transposition_en.pdf

As UCITS IV implementation is ongoing, this information is subject to change.

3. ESMA's Opinion on practical arrangements for the late transposition of the UCITS IV Directive, 13 October 2011, ESMA/2011/342.

KIID

The Key Investor Information Document (KIID) aims to provide clear, concise, easily understandable and easily comparable information to retail investors to enable them to make sound investment decisions. The KIID's two page format and highly prescriptive nature with five key headings certainly provides for more streamlined information to retail investors than was available under the Simplified Prospectus. However, managers have questioned whether the use of a Synthetic Risk Reward Indicator (SRRI) can accurately or appropriately encapsulate a fund's risk/reward profile in a single number. While the KIID is simple in concept, it has proven complex in reality involving the implementation of a whole new system of data collection, production, translation and dissemination as well as ongoing data monitoring and updating.

For many managers the complexity and specialised nature of this process has necessitated outsourcing part or all of the KIID production. Quality issues have also been surfacing, with German regulator BaFin recently expressing its dissatisfaction with content and the use of technical jargon in KIIDs.[4] The European Commission is eager for the KIID to succeed where the Simplified Prospectus has failed and we may expect further policing of the KIID requirements by European regulators in the future.

Management company passport

One of the key aims of UCITS IV is to enable a UCITS located in one EU member state to be managed, distributed and administered by a management company located in another EU member state via a 'management company passport'. The concept of a cross-border management company passport is not new and was considered under UCITS III but not comprehensively addressed until UCITS IV. Fund managers should be able to rationalise their European operations and expand more easily across the EU as the management company is no longer required to be located in the same jurisdiction as the UCITS, thereby enabling cost and management efficiencies. The anticipated early rush of UCITS management company consolidation did not materialise as member states and managers continued to focus on implementation of the mandatory requirements while tax complexities have discouraged managers from taking immediate action.

Tax was always going to be a stumbling block given that this area was not addressed in UCITS IV, despite it being one of the foremost considerations in keeping costs down. Key tax issues around the management company passport include whether the underlying UCITS will have a taxable presence in the management company home member state or vice versa, whether the tax residency of the foreign UCITS will be adversely affected under local rules, whether the new arrangement will give rise to double taxation and unexpected withholding taxes and whether there will be an impact on tax treaty access for the underlying UCITS.

The move to a single management company will be difficult to implement in the short to medium term due to tax complexities but opportunities for management company consolidation do exist and need to be carefully considered on a case-by-case basis following a thorough cost benefit analysis. In certain cases significant tax benefits can actually be achieved following management company consolidation.

The implementation of the Alternative Investment Fund Managers Directive (AIFMD) in 2013 could also present managers with the opportunity of creating a "Super ManCo" that could leverage efficiencies by managing both UCITS and non-UCITS funds under the one management company structure. AIFMD reflects the UCITS IV management company requirements and so there exists the possibility to use existing UCITS management companies to also manage AIFs under the AIFMD. As with the previous scenarios, potential tax consequences would be a key consideration.

4. "KIIDs riddled with jargon, study reveals", Baptiste Aboulion, Ignites, 14 December 2011.

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Management company passport location

Key considerations in determining the optimal location for your management company passport:

- Avoidance of adverse tax consequences triggered by UCITS IV reorganisation
- Low corporate tax rate
- Favourable VAT regime for investment funds
- Experienced and efficient local regulator with an effective outsourcing/delegation model
- Existing management company locations
- Location of Group HQ
- Local infrastructure and expertise
- Local operational costs
- Individual, case-specific factors

Master-feeder

UCITS IV permitted master-feeder structures and asset pooling within the UCITS framework for the first time in order to enhance cross-border operational efficiencies. Fund promoters may wish to retain a locally domiciled UCITS for tax and distribution reasons but can leverage efficiencies by transforming this fund into a local feeder or collection fund which in turn invests in a master-fund where assets from across local European markets can be pooled for more efficient management.

While the master-feeder would make operational sense for many asset managers with a number of local market funds in their range, again there are significant tax implications to consider. In a master-feeder reorganisation, treaty access or tax costs of the flows from the underlying investments should not be worse off than before the master-feeder. Tax leakage on payments from feeder funds to the master fund should be avoided while possible changes in tax status for the underlying investors should also be considered. A tax neutral master-feeder fund reorganisation can be challenging to achieve and requires careful cost benefit analysis before implementation.

Non-transposition of the Directive by EU member states has also meant that managers have not been able to avail of the master-feeder provisions in all jurisdictions. ESMA's Opinion of 13 October 2011 on practical arrangements for the late transposition of the UCITS IV Directive clarified that master-feeder structures should not be permitted if one of the two member states in which the UCITS are established has not transposed the Directive.

Notwithstanding these challenges, several asset managers are actively considering the master-feeder structure and this has coincided with an uptake in asset pooling more generally over the past few months. Tax transparent asset pooling vehicles, such as the Irish Common Contractual Fund (CCF) are increasingly being deployed by asset managers as a way of leveraging efficiencies and economies of scale at a global level by combining the assets of diverse structures such as pension funds, investment trusts and companies from different jurisdictions into a single pooling vehicle. A wider asset pooling structure could be considered within the context of a UCITS IV reorganisation.

Cross-border mergers

UCITS IV provided a harmonised framework for cross-border (and domestic) mergers of UCITS funds and sub funds regardless of legal form. With over 30,000 UCITS funds in existence across Europe there is considerable scope for rationalisation of fund ranges but again taxation issues can be formidable and create a variety of chargeable events and transfer taxes as well as possible changes in the tax status of underlying investors following a cross-border merger. The associated costs of effecting the merger must also be taken into account and under UCITS IV these must be borne by the management company and not the merging or receiving UCITS.

Notwithstanding these considerations, cross-border mergers can achieve cost efficiencies depending on the jurisdictions involved and the tax clarity and certainty provided by the jurisdiction of the receiving UCITS.

Conclusion – can UCITS IV deliver on efficiency?

UCITS IV has increased the level of regulatory requirements and compliance burden on management companies but its main purpose is still to deliver greater efficiencies. The much anticipated rush to consolidate has not materialised given tax uncertainties and the need to carefully consider and weigh up the advantages and disadvantages of such strategic moves. As was the case with UCITS III, there can be a significant time lag between implementation and the industry actually making use of the new provisions as the learning curve is mounted. Undoubtedly the UCITS IV efficiency measures would be easier to effect if they were accompanied by clarity at EU level on the tax treatment of the various provisions but this did not prove politically possible to achieve. Perhaps this will be one of the key recommendations in the European Commission’s report on the implementation of UCITS IV scheduled for 2013. In the meantime, the management company passport, master-feeder structure and cross-border merger provisions do present opportunities to enhance efficiencies that are likely to be availed of following careful cost-benefit analysis and as national tax authorities clarify their tax arrangements. As the fees squeeze continues in tandem with a steady rise in distribution, operational and regulatory costs, managers can ill afford to overlook the scope for cost saving under UCITS IV.

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How can Deloitte help?

Deloitte offers a complete range of professional advisory services to the investment management industry, including fund promoters, managers, fund administration businesses and custodians.

Our UCITS IV services include:

- Independent VaR model validation
- Asset pooling
- Risk management process review and guidance
- Key Investor Information Document (KIID) process and documentation review
- Strategic review of fund range and operations with cost benefit analysis
- Management company passport, master-feeder and fund merger project management

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