UCITS EVOLUTION - UCITS IV phase to reshape Europe’s fund landscape.

The 17th November, 2009 marked the publication of the UCITS IV Framework Directive in the Official Journal of the European Union with the new directive scheduled to come into force in July 2011. Much has been discussed and written about the implications of the implementation of the UCITS IV Directive with the key findings in various surveys that have been undertaken so far revealing that UCITS Fund Managers are gearing up for the new UCITS IV regime. The new regime is expected to strengthen the degree of harmonization across all EU Member States albeit one expects that this new framework will bring with it both challenges and opportunities for the European Investment Fund Industry.

Ultimately, one is hopeful that this will lead to consolidation at both the investor and service provider level which the industry very much beckons and thereon translate into increased competitiveness as a result of the cost efficiencies that are expected to be induced in the process.

In the last quarter of 2009, CESR published its advice on the UCITS IV implementing measures, covering both the Key Investor Information Disclosure Document (KID) and the much awaited management company passport. CESR has also submitted its technical advice on mergers of UCITS, master-feeder structures and cross-border notification of UCITS, together with its first wave of advice, specifically addressing the synthetic risk and reward indicator as well as ongoing charges. In summary there are five core matters that will be addressed in this new UCITS variant:

1. **Management Company Passport:** This will permit UCITS Managers to set up funds in any EU domicile, manage these cross border. The requirement for the Custodian to be based in the same domicile of the UCITS Scheme has been retained (a development that may be reconsidered when we come to UCITS V aligning this to the management passport that is being introduced under UCITS IV).

2. **Notification Procedure:** This development is intended to further strengthen the current CESR advice on the notification procedure and addresses the information a Member State should make available in relation to marketing in their jurisdiction of UCITS established in another Member State. This should instill increased clarity and guidance and therefore reduce subjectivity which in itself has somewhat proved to hinder efficient cross border fund passporting. The new procedure contemplates a template notification and attestation letter and provides guidance as to how the regulatory authorities of the home state provides access to the updated notification document, as well as which procedure should be applied for electronic transmission of notification files with the ultimate aim for these files to processed through a centralised IT system.

3. **Fund Mergers:** This covers the information that needs to be provided to unitholders of funds to be merged as well as the broad approach to be adopted in the circumstances.

4. **Master-Feeder Structure:** This will allow for the creation of master feeder structures. The feeder UCITS will be allowed to invest in excess of 85% of its assets in the units of one target UCITS (and the agreements that will have to be entered into between both entities including those for the custodian and auditor of the Scheme).
5. **Key Investor Information**: This will replace the simplified prospectus and facilitate the provision of clear unequivocal information to the end unit holder.

CESR’s advice has also extended itself to other related areas. These include the following:

(i) **The introduction of a synthetic risk and reward indicator**: CESR proposes methodologies for the calculation of this indicator. Starting from a general methodology (based on the volatility of the fund) it also addresses special cases, notably market funds with insufficient performance history, absolute return funds, total return funds, life cycle funds and structured funds.

(ii) **Ongoing Charges**: CESR defines what counts (or does not count) as ongoing charges which need to be disclosed. It outlines the methodology for the calculation of ongoing charges, dividing between existing funds and the case of new funds.

With all these new developments being brought to fruition one anticipates that the number of UCITS fund management operations managed by the same houses will be consolidated. In addition, one expects a wave of cross border mergers of smaller funds into larger funds. Coupled with the centralization of middle and back office services, one envisages leaner expense ratios as well as greater efficient cross border distribution processes.

Despite these welcome developments there are still a number of issues that need to be addressed. Surely enough leading the pack is the issue of taxation viz the tax treatment of investors under UCITS IV. EFAMA as well as a number of international firms have already raised these issues with the European Commission as to the need for the member states to focus on the domicile of the fund rather than the management company when applying income tax. In the case of cross border fund mergers, proposals have already been made for these to be tax neutral in the hands of the investor. The best approach would be one where a homogenous tax treatment is applied by all EU member states - a challenging option and possibly a utopian one!!

The Malta Financial Services Authority is actively following upon developments. In fact, on the 4th December 2009, the MFSA issued a Circular to brief the financial services industry on the developments concerning UCITS IV. The Circular provides a brief overview of the principal elements of the Key Investor Information (KII) together with information of CESR’s advice on KII. The Circular also provides an outline on how the Authority plans to transpose the requirements on the KII. In this regard, the industry is being consulted on the new rules which the MFSA intends to adopt in order to transpose the relevant articles in UCITS IV which set the requirements relating to the KII.

Kenneth Farrugia is the General Manager of Valletta Fund Services Limited, a subsidiary of the Bank of Valletta plc in Malta.