Ucits IV and what it will mean for investors

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In July 2011, a new set of Ucits legislation will be upon us. From the press around "Newcits" funds, you would be forgiven for thinking that the industry is still digesting Ucits III and the broadening of investment powers that this brought to the portfolio manager. In this article, we provide an update on Ucits IV and highlight some of the key benefits it will bring to investors.

The goals of Ucits IV are to bring efficiencies to the management of funds and increase investor protection through simplified product disclosure. The European Commission has looked enviously at the U.S. mutual funds markets in which average asset sizes are high and average costs are low. Have our regulators succeeded in bringing a more effective framework for mutual funds in Europe?

Pan-European marketing of Ucits funds

Ucits IV seeks to cut the time to market for funds to be registered for retail distribution. Historically, it has been time-consuming for promoters to get funds registered for retail distribution; with up to two to three months lags between a fund's launch in the home state and its availability for marketing in the host state. For investors, this has felt like a European cinema buff waiting for the latest Hollywood blockbuster to finally arrive in his local cinema.

This directive seeks to cut the time to market to a maximum of ten working days between a complete submission by the promoter and marketing being able to start. Although this appears a welcome step forward for investors, allowing access to new funds more rapidly, a word of caution is required. Local marketing requirements have been another barrier to effective local distribution. These must now be clearly stated – however onerous, this could still reduce time to market for investors in certain jurisdictions.

Management company passport (ManCo)

The directive enables funds to be managed in one member state by a ManCo in another member state. Whilst of interest to promoters, this proposal is unlikely to make a material difference to investors.

Key information document

Every Ucits fund (and potentially share class) will be required to produce a *Key investor information document* (KIID). It replaces the *Simplified prospectus* which is generally perceived to have failed in its aim to be an investor-friendly pamphlet – indeed, some simplified prospectuses are longer than the prospectuses which they seek to summarise. The KIID is a 2-page "fact sheet"-style document with a prescribed format of under 5 key headings, intended to harmonise investor information and help investors make comparisons between Ucits funds. The production of these documents represents a real challenge for promoters – but for investors this looks like good news. It introduces a short pre-contractual document, with the onus on the promoter to provide a clear and accurate representation of the key information required before making an investment decision, including objective, risk, charges and performance.

Mergers of Ucits

Cross-border mergers have historically been possible, but cumbersome due to onerous, somewhat protectionist local provisions, for example on voting requirements. The new rules create an improved framework for cross-border mergers, which is a welcome addition to the product development tool kit – however it is critical to note that there is no corresponding EU-wide harmonisation of the tax implications for fund mergers. Hence, there will still be complex multi-jurisdictional tax advice required for investors to understand the impact of proposed mergers, which is likely to delay the widespread uptake of cross-border mergers.

Between key jurisdictions (e.g. Luxembourg, Dublin and the UK) the body of case law will be gradually put

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in place. In five to ten years, expect this to have a bigger impact.

The new rules also introduce the requirement that investors in both the closing and receiving fund are notified of the proposed merger. This applies to both domestic and cross-border mergers and is a less welcome provision, which will increase costs with questionable benefit to investors in the receiving fund. We anticipate that the volume of domestic Ucits fund mergers is likely to increase in the run-up to Ucits IV being introduced, to avoid this new provision.

Feeder funds

Ucits have historically not been able to feed into other Ucits. The new rules allow for a Ucit to invest between 85% and 100% into another Ucits fund. This creates the possibility for master feeder structures. This is the only new investment power in the directive and is an area we are taking a closer look at.

To date, we have identified four key ways in which Ucits IV feeder funds may be used. First, rationalisation of investment platforms. Where promoters have multiple funds offering the same strategy, it may be efficient to turn the smaller funds into feeders into a master. Second, customisation of existing investment strategies. Ucits IV mandates that 85% of assets of a feeder must be invested in a master. That leaves 15% for currency hedging and cash management. More innovative uses could also be made of the 15% bucket – e.g. beta hedging, duration hedging and tactical asset overlays. Third, becoming more local to investors. Managers can now launch Ucits in a member state (e.g. France) that feed into masters in a core cross-border jurisdiction (e.g. Luxembourg or Dublin). This may enable investors to buy a product which suits their own regulatory regime and local preferences whilst still benefiting from the scale of large cross-border pools. And fourth, responding to the changing face of distribution – distributors may find it valuable to launch co-branded feeders. In addition, fees can be unbundled between the distributor and the investment manager – avoiding the need for rebates.

Conclusion

For investors, Ucits IV will arrive with a whimper rather than a bang. There is no headline grabbing liberalisation of investment powers – rather a set of largely sensible rules around the management of Ucits funds with a view to honing the single EU market for mutual funds and providing improved investor disclosure on products. Will Ucits IV lead to a consolidation of investment funds and the reduction in costs that our U.S. colleagues benefit from? Only time will tell. In our view, the Ucits brand will continue to be strong – but the real rationalisation benefits from Ucits IV will take years for investors to realise. At BlackRock, we are regularly holding educational sessions for our clients around the Ucits IV directive to discuss developments from a distribution, consultant, asset manager and investor perspective.

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