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Regulatory Update

UCITS IV | RDR | AIFM Directive | TEFs | Protected Cell OEICs

Jul 09

Timeline



Mar 2009 EC sent directive to CESR to request technical implementation advice

Oct 2009 CESR expected to deliver implementing advice

End 2009 FSA and HMT start the process of implementing UCITS IV in the UK

Early 2010 Publication of first working document on possible level 2 legislation

Early 2010 Formal Commission proposal for level 2 legislation sent to European Securities Committee

1st Jul 2010 Formal adoption of level 2 measures by the Commission

1st Jul 2010 Final implementation of UCITS IV

Impacts

- Significantly increases the ability of fund managers to rationalize their pan-European fund ranges. Any managers with multiple market-specific fund ranges will be able to consolidate the ranges into a single jurisdiction
- Cross border mergers will achieve greater costs savings and legacy fund ranges can be consolidated
- The Management Company Passport will allow Luxembourg and Dublin fund ranges to be managed from different countries, without the current requirement for “mind and body” control in the local domicile allowing de-duplication of functions and cost savings

Key points

Cross Border Mergers

- Harmonisation of procedures for cross-border mergers and the required level of information available to investors
- Both merging and receiving UCITS to provide an “information letter” to their respective investors on the proposed merger
- Investors will be able to decide whether they want to stay invested
- Time prescribed approval from Regulators of both the merging and receiving UCITS
- Depositary/independent auditor certificate of compliance required

Master-Feeder Structures

- UCITS IV allows asset pooling through master-feeder structures. UCITS funds (feeders) can invest 85-100% of assets into another fund (master). Any balance may be invested in ancillary liquid assets, financial derivative instruments (for hedging purposes) and/or movable and immovable property
- Agreement between feeder and master UCITS outlining internal conduct of business rules
- Time management between Master and feeder UCITS of net asset value calculation and publication to avoid ‘market timing’
- The master UCITS’ depositary responsible for reporting irregularities to all parties

Management Company Passport

- A fund manager authorised to operate CIS in one member state will be permitted to operate in all other European jurisdictions by establishing branches or under the freedom to provide services
- Written agreement likely to be required between management company and depositary in cross-border situations
- Manager will need adequate cross-border risk management processes to monitor and measure risk at all times

Actions

1. Conduct strategic review of fund ranges and identify opportunities for rationalisation
2. Look to consolidate operating model in advance of legal fund mergers, e.g. rationalising service providers, administrators, transfer agents
3. Make short term cost savings where possible in funds and management functions in anticipation of UCITS IV implementation in 2011



Timeline



Jun 2009 New rules published for consultation by FSA

30th Oct 2009 Consultation closes

Q1 2010 Final rules published

31st Dec 2012 New rules in effect

White Paper “The Impact of the Retail Distribution Review on Wealth Managers” – available now contact Lisa Tye.

Impacts

- **Exit of IFAs.** Combined effect of increase in capital and retraining requirements expected to prompt a significant minority to leave the industry
- **Wider use of ETFs and Investment Trusts.** The need to review all relevant products together with the increased transparency of charging will increase the pressure on fund charges and increase the use of ETFs and Investment Trusts
- **Greater ‘industrialisation of processes.’** The need to review a wider range of products together with the downward pressure on fees caused by increased fee transparency will require greater standardisation and automation of processes

Key points

Advisor Charging

- The charge for advice must be separated from product charges. It must be fully transparent and set between the customer and the advisor. A platform or product provider may collect the advisor charge, but may not influence the level. Collection of the charge from the client must be at the same time as payment to the advisor

A New Standard for Independence

- There is a new requirement to review all products that could serve the relevant market. ETFs and National Savings products need to be considered alongside Bonds and OEICs

Disclosure of Status

- If the standard for independence is not met, then service must be described as ‘restricted advice’. Initial customer research shows HNW clients will be deterred from using a service using this description

Professional Standards

- Higher (QCA level 4) levels of training required for all advisors, including those giving restricted advice within product providers

Actions

1. **In-house OEICs – Wealth Managers and IFAs** with their own range of OEICs should provide feedback to the FSA on rule 6.2.A.13
2. **Review Training Needs** – the new requirements should be built into training plans leading up to end 2012
3. **Maximize Value of Exiting IFAs** – firms from all parts of the industry should look to get the best value from IFAs exiting the industry
4. **Review Business Model** – all parts of the market will be heavily affected. Firms need to review their product and service offerings and pro-actively engage with the new market realities

[Click here to access FusionExperience's white paper on the Retail Distribution Review](#)

Timeline



Given the political storm over the Directive, timescales are very high level at present:

End 2009	Political approval for proposed Directive
2011	Full implementation

Impacts

- This Directive covers managers of **all non-UCITS collective investment** funds not just Alternative Investment Funds (AIFs)
- Managers of AIFs once authorised may market funds to professional investors in all states, subject to a simple notification procedure. This levels the playing field for cross-border marketing that is highly restrictive in some states today
- The Directive's proposals on Depositary liability (and the potential write-across to UCITS) as they stand will lead to significant market disruption – the exit of a significant number of leading players from the market or an increase in customer costs of >100bp per annum

Key points

Scope

- All managers of non-UCITS funds must be authorised under the Directive, subject to *de minimis* limits (€100m or €500m for Private Equity-type funds)
- Funds domiciled outside the EU (e.g. three-quarters of all hedge funds) may be marketed cross-borders after a three year waiting period. Individual countries may allow “third country” funds to continue to be marketed during this three year period if they do so currently

Valuator and Depositary

- All funds must appoint an independent “valuator” (fund accountant) meaning that all fund accounting activity for all non-UCITS funds (including retail schemes) would have to be outsourced to a third party
- All funds must appoint an independent depositary to receive client moneys and safeguard assets. The Directive removes any limits the Depositary's liability and reverses the burden of proof. These latter changes will have significant impacts on the Depositary and Custody market

Disclosure and Regulator Powers

- The Directive sets minimum standards (to be defined) for disclosure to investors and for ongoing reporting to the local Regulator
- Managers that are managing “highly leveraged” funds – more than 200% gross exposure – have additional reporting requirements and local regulators have the power to restrict leverage limits across the board or on specific managers or funds. This has led to some hedge fund managers looking to domicile outside the EU

Capital

- Fund managers must have minimum capital requirements that are linked to assets under management (€125k plus 2bp on AUM over €250m), which will increase the capital required by some managers

Actions

The Directive was significantly flawed in its original drafting, however it is likely to go through in one form or another. All parties are being asked to:

1. Analyse the impact on their business and define the costs and issues involved
2. Focus on those areas that are most problematic and have the highest impact
3. Feed these concerns back to your industry body, the FSA, and HM Treasury. The sooner the better



[Click here to access FusionExperience's full article on the impacts of AIFM](#)



Timeline



Apr 2009	Draft regulations published
1 Sept 2009	TEF regime due to be introduced

Impacts

- Provides more flexibility on the structure of funds. The real benefit to clients is however muted by the effective taxation of property income even for tax exempt clients
- Expect a limited launch of TEFs in the Autumn as managers test out the new regime
- Unlikely to halt the move of fund managers from the UK to Ireland and Luxembourg as the punitive SDRT regime remains and TEF funds are inefficient for multi-asset funds containing property

Key points

Aims of the Legislation

- The new Tax Elected Fund (TEF) regime is intended to enable UK Authorised Investment Funds to market themselves more competitively enhancing their attractiveness compared with offshore funds
- The regime aims to move the point of taxation from the fund to the investor, so investors are taxed in the same way as if they had invested directly in the underlying assets of the fund

Income Streaming

- Income will be streamed in the distributions paid out by a TEF. There will be two streams, dividends and non-dividends. Dividend income will include both UK and foreign dividends and also property income. The non-dividend distribution will include all other income (e.g. interest)
- TEFs will be able to invest in UK REITs or UK PAIFs but will have to receive property income net and will not be able to recover any income tax deducted at source

DTAs and Investor Impact

- TEFs should still be able to access Double Taxation Agreements as they are technically still subject to tax. This is a key requirement as one advantage the UK has is a very widespread range of DTAs, compared particularly with Dublin and Luxembourg
- The TEFs will still have to withhold tax at the basic rate on non-dividend distributions to tax-paying investors
- The regime is elective so funds can remain in the current equity or bond regimes if required

Actions

1. Review existing Authorised Investment Fund range in light of new regime
2. Assess customer impact – if many clients are exempt or this is a target client market there may be opportunities by electing in, particularly ahead of the rest of the market
3. Assess funds and investments – generally mixed bond-equity funds will benefit most from the new regime, but a full analysis should be carried out



Timeline



Jul 2009	Consultation paper issued
27 Sept 2009	Consultation closes
Late 2009	Regulations implemented
Late 2010	Transition period complete

Impacts

- Under current law there is no segregation of liabilities between different sub-funds within the same UK OEIC. The Protected Cell proposals would change this so that no sub-fund had claim over the assets of another
- Prospectuses, Instruments of Incorporation and all third party agreements will need to be updated to reflect segregated liability
- Existing customers will need to be notified of the change as part of the normal communication cycle (there will be no need for shareholder approval)

Key points

Aims of the Legislation

- The legal structure of UK OEICs has the largely theoretical possibility of contagion between sub-funds. In the event of the insolvency of one sub-fund, assets of other sub-funds could be used to meet the liabilities
- While this risk is disclosed in prospectuses and Report & Accounts, it is not clear that retail customers fully understand the risk
- This legislation will remove the possibility by treating each sub-fund as a separate legal person in the courts in case of insolvency

Competitive Position of UK OEICs

- While there has been no legal precedent in the courts of asset contagion between funds, the current framework has driven some investors to other jurisdictions such as Luxembourg, Ireland and Jersey, where sub-funds are already legally segregated
- Therefore the legislation is expected to enhance the competitive position of UK OEICs

Cross Sub-Fund Holdings

- At present the sub-funds within one OEIC umbrella may not invest in other sub-funds within the same OEIC umbrella. The Consultation Paper proposes to change this

Compulsion

- To avoid consumer confusion all UK OEICs will be required to move to the new regime
- The new rules will come into effect as soon as parliament approves them. There will be a one year transition period

Actions

1. Review proposals to determine any effect on existing funds and new product launches
2. Review existing documentation and agreements with third-parties to understand impacts of segregation of liabilities
3. Integrate prospectus updates and customer notifications into normal communication cycle



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