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Getting ahead

UCITS IV: Putting the potential into action

The European Union's (EU) directive, Undertakings for Collective Investment in Transferable Securities (UCITS) – a framework for the regulation of mutual funds in the EU – has been undergoing a makeover. The changes, known as UCITS IV, come into effect in just two years. So, preparing now for what will likely be sweeping changes, is paramount for firms keen to benefit from the efficiencies available.

The global financial crisis and its wider economic repercussions have had a severe impact on the sector, with total assets in UCITS funds falling 22 percent (or €1.77 trillion) last year, while net outflows from UCITS hit €335 billion¹. The situation has since brightened somewhat, with the European Fund and Asset Management Association (EFAMA) recording net inflows of €30 billion into UCITS in the first two months of 2009. Nevertheless, question marks remain over the viability of many of the funds still in existence in today's highly fragmented European funds market. With this as background the changes come at a crucial time.

The six major amendments it introduces – the so-called 'Efficiency Package' – have been widely applauded by the industry as a valuable toolkit that can enhance the effectiveness of the UCITS framework, and will offer significant efficiencies to fund organizations operating within it.

The regulatory changes that make up the package will create significant opportunities for investment management firms to:

- i.** Cut the number of management companies operating across Europe by leveraging the Management Company Passporting scheme, and hence reduce costs and capital requirements
- ii.** Concentrate assets in their best performing funds and so improve returns
- iii.** Decrease total expense ratios through a centralization of the middle-office and administration services
- iv.** Reassess the fund administrators and custodians they use to service the funds
- v.** Reduce time-to-market and administration costs for funds sold cross-border



Figure 1

Plan of campaign framework

1. Understand and document the 'as-is'
2. Undertake the market analysis
3. Develop the hypothesis for the 'to-be'
4. Design the operating model
5. Challenge, validate and approve

Planning for Action

With UCITS IV slated to come into force in July 2011, planning and developing clear and strong product strategies now will enable firms to get a headstart in the greater flexibility the new directive will give. Firms should plan now those fund ranges they expect to close, so that they can start to be wound down making eventual closure easier. Similarly, new fund launches can be restricted to those fund ranges which will have a long term strategic future. By doing this, firms can plan in advance those areas they expect to close, funds to consider winding down and possibly avoiding launching, making the eventual implementation of UCITS IV easier.

Critical to this strategy will be an understanding of how to leverage the triumvirate of measures being introduced: the framework for cross-border mergers, master-feeder structures, and the Management Company Passport. A successful product strategy though, will depend on the idiosyncrasies of each fund promoter's business model and the product range they currently offer, and as such must be forged on a case-by-case basis. Following the herd will no longer be the best solution (see figure 2).

For example, while the provisions on cross-border mergers pave the way for consolidation, depending on the countries involved, tax liabilities may arise and will need to be taken into account. Taxation considerations fall outside the UCITS remit and so vary substantially from country to country. The impact of this on firms will vary according to strategy developed.

The location freedom offered by the Management Company Passport raises similar considerations. For instance, some firms that have their investment management and product development functions in one of the larger countries such as the UK, may opt to centralize the management company function there as well. Others may prefer Luxembourg or Ireland, because of lower tax rates and fund center status, or one of the Eastern European countries given their lower cost bases.

But then there is the question of where to domicile the master fund. For instance, to date Luxembourg has been the customary jurisdiction for retail funds, not least because of the brand recognition Luxembourg UCITS have achieved around the world. And post-UCITS IV these traditional fund centres are likely to retain an advantage as domiciles of choice, given their wide range of tried and tested fund servicing structures.

Tax Uncertainties

The area of greatest uncertainty surrounding the UCITS IV provisions and their potential benefits will not be addressed at all in the current process – the tax implications that surround the Management Company Passport, cross-border mergers and the establishment of master-feeder structures?

Depending on the rules of each jurisdiction, cross-border mergers may trigger tax charges, including capital gains tax and stamp duty, even though investors do not realize their investments at the time a merger occurs. In addition, there will be cases where investors could face higher tax rates following a merger than if they had remained invested in the original fund, these issues need to be identified and addressed early. Resolving this across the different countries in the EU will require a separate UCITS tax directive. That though, is years away.

An approach KPMG firms have found helpful with clients to develop strategies is shown in figure 1.

The option of waiting for total clarity on UCITS IV to be implemented may not bring the best success in the medium to long term. For those acting now to navigate the complexities, the rewards should be worth the effort.

Figure 2

The UCITS IV 'Efficiency Package'

Undertakings for Collective Investment in Transferable Securities (UCITS) are regulated investment funds domiciled within the EU and capable of being sold across borders. First introduced in 1985, the aim of UCITS was to integrate the EU market for investment funds by offering greater investment opportunities to investors, as well as greater business opportunities to the asset management industry. Since then UCITS have become a world-renowned brand, enjoying considerable success not only in Europe, but in markets in Asia, the Middle East and Latin America.

UCITS IV, which is due to come into effect in July 2011, introduces six headline changes to the regime:

- i. A full Management Company Passport, allowing a UCITS to be managed by a management company authorised in another member state
- ii. Establishment of a framework for fund mergers – no rules exist at EU level in this area at present
- iii. A new framework for master-feeder structures – again, no rules for such structures exist at present at EU level
- iv. Replacing the Simplified Prospectus with a Key Investor Information document
- v. A new regulator-to-regulator notification procedure to speed up the cross-border funds distribution process
- vi. Improved supervisory cooperation mechanisms

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1. The European Fund and Asset Management Association (EFAMA) pointed out in its report, *Trends in the European Fund Industry in 2008*.

2. For a fuller discussion on this topic please see article 'Tax obstacles to the success of UCITS IV' – included in the latest edition of *frontiers in tax*, KPMG International, June 2009.