

UCITS IV

What are the implications of the UCITS
Management Company Passport?

November 2009

Since end of 2008, it is clear that UCITS IV will allow UCITS management companies to set-up and operate on a remote basis UCITS established in another EU Member State. On 28 October 2009 CESR published its technical advice to the EU Commission on implementing measures related to the UCITS Management Company Passport (MCP). The new legislative framework will impact all European UCITS Management Companies even those which do not intend to make use of the passport.

Indeed, at the end of 2008, more than 65% of the top 30 cross-border group promoters have more than 3 different countries of domicile for their UCITS funds. As a consequence, they also have several management companies ('ManCo') fulfilling resources and capital requirements. Out of this sample, 6 promoters have UCITS ManCos in more than five countries!

However, rationalization at ManCo level must take place in the context of a global strategic positioning of the fund organization and of the products.

For example, the MCP is a component of UCITS IV without which other measures like the possibility to have UCITS master-feeder structures would be largely deprived of efficiency. The VAT package 2010, the potential need to continue local management of non-UCITS funds or the necessity to keep local operations for distribution purpose are other examples of elements to take into consideration before taking any strategic decision. An in-depth analysis of the benefits and the inconvenience of such rationalization is therefore more than recommendable.

Scope of the UCITS IV MCP

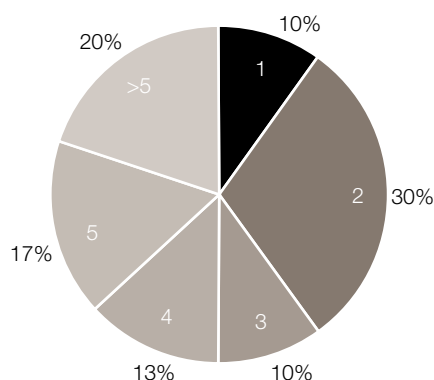
The UCITS IV Directive applies to UCITS management companies only. In particular, UCITS ManCos which also manage local non-UCITS funds will have no passport under this Directive which would allow them to manage non-UCITS in other EU countries. This situation may change if the future Alternative Investment Fund Manager Directive provides a passport for the non-UCITS activity, but this passport would only be available for sales to professional investors.

Background

Consolidation needs?

UCITS III could not resolve all the blockages related to the passport of UCITS management companies. In UCITS IV a compromise was found and the necessary framework for an effective passport has been implemented. The Management Company Passport ('MCP') should facilitate the integration of the European fund market and at the same time should help reducing costs of local management company structures.

Number of UCITS management companies domiciles per group



Source: Lipper - PwC Analysis: Top 30 cross border group promoters - figures end 2008

Core requirements of UCITS IV

UCITS domicile, applicable law, split supervision

- Under UCITS IV, the domicile of the UCITS will necessarily be the Member State where the UCITS has been authorized.
- The law of the UCITS home Member State regulates the constitution and functioning of the UCITS notably regarding the set-up and the authorization process, the merger, the liquidation and the investment policies & limits, NAV errors / investment breaches, etc.
- The law in force in the home Member State of the ManCo regulates its organization, including its ability to delegate its activities (in the same country or abroad), the risk management regime to put in place and provides the applicable rules of conduct and the rules for prudential supervision of the ManCo.

Maximum alignment with the MIFID rules

- CESR technical advice largely regards application of MiFID organizational and conduct of business rules to ManCos in order to facilitate the mutual recognition between MS regulators in the context of the passport. Impact is moderate in MS where MiFID rules already apply to ManCos to a certain extent.

MiFID organizational rules (Governance)

- ManCos should set-up independent compliance and internal audit functions; these functions can be delegated at certain conditions.
- ManCos should establish, implement and maintain effective procedures in relation to complaints handling, personal transactions, recordkeeping (portfolio transactions, subscription and redemption orders).
- CESR advises that Level 2 measures provide detailed rules regarding the identification, prevention, management and disclosure of conflict of interests.

MiFID conduct of business rules

- ManCos have a duty to act in the best interest of UCITS and investors. This should imply accurate asset valuation, market timing and late trading prevention, transparency and duty to prevent undue cost for investors.
- ManCos should implement documented and effective arrangements to ensure that investment decisions on behalf of the UCITS are carried out in compliance with the investment policy and the risk limits of the UCITS.
- In case of direct sale of fund units, ManCos should act honestly, fairly and professionally in accordance with investors interests. ManCos should test if investment is appropriate for the investor (Appropriateness test), handle client orders according to fund prospectus and provide detailed reporting on subscriptions and redemptions to investors.
- ManCos should take all reasonable steps to obtain the best possible result when executing transactions for the UCITS (Best Execution).

MiFID inducement rule

- CESR considers that inducements are one of the main sources of conflicts of interests in the context of portfolio management and merit specific regulation.
- All payments received or made in relation to collective portfolio management services (portfolio management, administration, marketing) must satisfy 3 conditions:
 1. They are adequately disclosed to the UCITS (and to the unitholders via durable medium) before rendering the service.
 2. They are designed to enhance the quality of the relevant service.
 3. They do not impair compliance with ManCo's duty to act in the best interest of the UCITS.

MiFID inducement rule – two exceptions (no conditions)

- Fees, commissions or non-monetary benefits paid or received by the UCITS.
- Fees which are necessary for the provision of the relevant service and which by nature do not generate conflict of interests (proper fee).

Additional non-MiFID provisions

- ManCo's senior management is responsible to approve and monitor periodically the general investment policy of the UCITS.
- ManCos should implement basic principles regarding the organization of the accounting to ensure permanent identification of UCITS assets & liabilities and accurate valuation of assets and NAV calculation.
- ManCos should implement policies in relation to the remuneration of staff whose activities materially impact the risk profile of the UCITS managed by the ManCo.
- ManCos should, to the exclusive benefit of unit-holders, apply strategies for the exercise of voting rights attached to the instruments held by the UCITS.



These rules will apply to ManCos even if these ManCos do not make use of the passport



ManCo keeps responsibility in case of delegation to third party. This implies that the third party will have to fulfill all the organizational, conduct of business and conflict of interests requirements in relation to the activity to be carried out (due diligence)



CESR considers that its advice should apply also to self-managed UCITS



Application of the proportionality principle – i.e. the possibility to take into account the nature, the scale and the complexity of the business to design appropriate and proportionate measures to comply with regulatory requirements

Depository

- The depository continues to be located in the same country as the UCITS.
- It must have access to the information necessary to carry out its monitoring tasks on the management company. For that purpose, an agreement regulating the flow of information has to be concluded between the management company situated in another MS and the depository.
- CESR proposes general requirements on the content of the contractual arrangements to be in place between the ManCo and the depository.
- CESR considers that required arrangements between the ManCo and the depository should also be taken when the UCITS and the management company are in the same Member State.
- Definition of the role and the responsibility of the UCITS depository has been left to the EU Commission (EU Commission consultation July 3, 2009) and is not covered by CESR technical advice. (CESR however replied to the consultation on 17 September 2009).

Risk management

- The distinction between sophisticated and non-sophisticated UCITS will be abandoned. The labeling will be replaced by distinct calculation methods for global exposure.
- The global exposure is defined as market risk only. Depending on the measurement method used, global exposure means the leverage on derivative positions or the market risk of the whole portfolio.
- CESR recommends an assessment of all risks and their materiality within the overall risk profile of the UCITS. Liquidity and operational risks are explicitly designated to be material.
- VaR calculation methods will be reviewed and guidance issued before July 2010 by CESR.
- The need for fair valuation is extended to all complex and/or structured and/or illiquid products.
- The Risk Management function will be responsible for reviewing the valuation of OTC derivatives, structured products and illiquid products. The valuation models used for fair valuation and Risk Management shall be the same.
- The Board of Directors needs to be informed on a regular basis on Risk Management issues. Adequate resources within the Board have to be allocated.
- A reporting function should be appointed which informs the Board as well as the "Senior Management" (i.e. conducting officers) on a regular basis. The reporting should be specific to the different recipients (i.e. different reporting contents for BoD and Senior Management)
- Counterparty Risk is measured on the basis of the positive Mark-to-Market value of the contract (no add-on for future credit exposure). Securities Lending and repurchase transactions have to be taken into account when calculating counterparty risk.

Main business implications for the UCITS industry

Main organisational impacts for ManCos

The Level 2 measures impose a multitude of new requirements on the existing ManCos. A potential consequence can be the consolidation of the ManCos in small markets or countries in which traditionally such ManCos existed for distribution purposes only. Another option could be to maintain local operations but transforming the local ManCos into branches.

In any case, fund promoters have to take into consideration many elements to ensure adequate risk/return on their operations:

Location & set-up

- Definition of target corporate set-up
- Identification of best country of location
- Definition of management company organization and Risk management process
- Governance
- Human capital and recruitment.

Tax & Legal

- Taxation
- (personal tax, VAT and corporate tax)
- Substance issues
- Cooperation between fund and management company respective countries of domicile
- Transfer of contractual arrangements
- Delegation arrangements.

Fund range & distribution

- Re-domiciliation of funds
- Management of non-UCITS funds.

What are the critical business issues?

Interpretation of the proportionality principle?

Key challenge will be to reach compliance with MiFID organizational measures without taking un-necessary or excessive arrangements. The application of the proportionality principle gives flexibility to the ManCos, but the minimum requirement will have to be assessed by the ManCos depending on the business decisions they have taken.

Delegation to 3rd parties and distribution networks?

New organizational and conduct of business rules may as well be a real challenge especially when the activity is delegated to non-MiFID entities (e.g. distributors outside EU). ManCos will, where necessary, have to contractually impose to their service providers additional and documented MiFID behavior (e.g. appropriateness checks of investors).

Inducements and distribution networks?

Finally, the rule on inducements may force ManCos and the whole industry to reconsider the remuneration model in the value chain and could lead to a fundamental change in how distribution will have to be overseen by the ManCos. These requirements are in-line with the transparency on charges in the KID and the RDR initiative of the UK.

What are the tax issues?

ManCo passporting may lead to situations where the only link with the country of domicile of the Fund is its incorporation in this country (plus auditor, custodian and supervision by the local regulator) and therefore, where residence, management, control and substance of the Fund can be much more easily challenged. Tax consequences may be various, like e.g.:

- Double taxation both in Fund's country of domicile and in Manco's country of domicile.
- Taxation in the country where key management decisions are actually taken, i.e. ManCo domicile country.

Transfer pricing policies should also be carefully monitored as use of the MCP may evidence transactions not performed on an arm's length basis and raise questions by tax administrations.

Finally, **exit tax** costs upon migration can also be significant and a proper tax analysis should be carried on to locate management activities in a country with competitive effective tax rates.

The VAT package 1st January 2010

As of 1 January 2010, the VAT Package will enter into force. The primary impact of the VAT reform for the asset management sector is that services taxed where the supplier belongs will now be taxed where the recipient belongs. Considering the VAT implications as part of the re-organisation plan and re-domiciliation decision may allow taking advantage of opportunities and mitigating VAT costs.

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PricewaterhouseCoopers has one of Europe's leading networks of UCITS specialists, based not only in the key asset management centres but also throughout the EU. Our complementary skills in areas such as regulations, tax, HR, restructuring, market reporting, risk and operations enable you to undertake the holistic analyses needed to make the most of the possibilities of UCITS IV. Every promoter's set of circumstances is different, and only strategies based on detailed appraisals will yield the full efficiencies the directive makes possible. We have been part of the evolution of the UCITS market since the first directive in 1985, and have closely tracked the development of the latest directive. For these reasons, we have the insights and expertise that you need.

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