

UCITS III News

Pan-European UCITS III Newsletter

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Since early 2003, the PricewaterhouseCoopers UCITS III Champions Group has been constantly tracking first the implementation and then the various evolutions of UCITS III.

Over the course of the past 4 years, we have issued 14 Pan-European Newsletters, each one of them summarising the impact of UCITS III on our clients across a host of important topics.

For those who have followed this evolution closely, you may remember that the EU Commission was silent for a long time after enacting the two Directives in 2001. Its UCITS Contact Committee, in charge of assisting to clarify certain areas of the directive, has only prepared EU Recommendations on Simplified Prospectus and Derivatives, two documents which themselves raised more questions than answers. EU regulators and fund promoters were left alone to deal with complicated transitional issues, for the products and the management companies, and for the simplified prospectus.

Some may remember the complexities raised by these transitional provisions: with three dates (February 13, 2002, February 13, 2004 and February 13, 2007) in two different directives (Product and Profession), each triggering a different set of rules, the combinations were many – and turned out to be quite a mess in terms of the cross-border passporting of UCITS! At the time many cross border promoters expressed disbelief at the confusion, e.g. Spain refusing UCITS I products because they did not have a simplified prospectus, Italy turning down UCITS I funds created after 2004 or UCITS III products using an “old” UCITS I management company and the French postponing the authorisation of any post-2004 UCITS I sub-fund on its territory.

There were other occasions when host authorities would refuse an importing fund the right to distribute because of its investment policy, say because that fund was accepting certain types of investment in its 10% trash ratio or allow for certain commodity indices at times when no one was even thinking about stretching the term “financial indices” to such an extent.

CESR, the useful successor of the UCITS Contact Committee has, with its recommendation on transitional provisions of UCITS, assisted in putting an end to the array of passporting issues flowing out of UCITS III. The Commission’s recent directive on eligible assets, itself based on the work done by CESR in that respect, will hopefully clarify remaining product issues and avoid, in the future, the passporting nightmare lived by many during 2004 and 2005.

So, is everything fine in the UCITS III world?

A few months after the end of the transition period (February 2007), and in the wake of proposed changes to the good old 85/611 Directive, the UCITS III Champion Group met yet again looking to “wrap-up” 4 years of UCITS III and see where we stand.

Not surprisingly, full harmonisation is not complete and in certain areas additional work remains. We have looked at areas that have been analysed in the past, to see whether over the years countries have evolved on their interpretation regarding:

- The Simplified Prospectus
- Sophisticated/non sophisticated UCITS
- Risk-management approaches
- Ancillary cash
- Management companies, delegation of functions, use of passport

1. The Simplified Prospectus

It may well be that this document, foreseen in Annex C of the UCITS III directive and detailed in the Commission's 2004 recommendation, is doomed: given the latest reflections of the Commission, as stated in its successive Green and White papers and its Exposure Draft of March of this year, it may be replaced by "Key Investor Information", the form and content of which is still unknown.

The following chart, already used in Issue 11 of our UCITS Newsletter, in May 2005, shows the current local divergences on information relating to costs in a fund. We have colour-coded those responses which have changed since May 2005.

Is the following information required for your local simplified prospectus?	AT	BE	DE	DK	ES	FR	IR	IT	LU	NL	SW	UK
(1) Total Expense Ratio	Y	Y	Y	N	Y	Y	Y	Y	N	Y	Y	Y
(2) Audited Total Expense Ratio	N	N	N	N	N	Y	Y	N	N	N	N	Y
(3) Portfolio Turnover Rate	Y	Y	N	N	Y	Y ²	Y	Y	N	Y	Y	Y
(4) Fee-Sharing	Y ¹	Y ¹	N	N	N	Y ¹	N	Y	N	Y ¹	N	Y
(5) Soft Commission	Y ¹	Y ¹	N	N	N	N	N	Y	N	Y ¹	N	Y

¹ Reference must be made to the full prospectus which must contain more detailed information.

² Only for equity funds.

If indeed the aim of the simplified prospectus was, among others, to permit a comparison between products from different territories (say, for example, a Luxembourg UCITS sold in France compared to a French UCITS), this chart shows that evidently, it has failed.

Whether such information on cost should indeed appear in a simplified prospectus and be understood by the investors is yet another question, which we all hope to get an answer to soon.

2. Sophisticated UCITS

With the inclusion of financial derivatives as eligible assets for a UCITS funds, UCITS III has paved the way for much more innovative investment strategies, generally much harder to comprehend for the investor than under the previous regime. In 2004, the Commission's recommendation on the use of derivatives created the term "sophisticated UCITS", without however defining it, and imposed a risk management approach appropriate to that sophisticated nature.

We have tried to find out whether local countries diverge very much from one another in determining what a "sophisticated UCITS" is. We also wanted to know whether and what specific Value at Risk limits are imposed or recommended locally, when such risk management method is used:

	AT	BE	DE	DK	ES	FR	IR	IT	LU	NL	SW	UK
Definition of “sophisticated UCITS”	N	N	N	N	N	N	N	N	Y	N	N	N
Other elements in regulation allowing assessment of “sophisticated character”	Two lists of derivatives exist: the plain vanilla ones, allowing commitment approach – the sophisticated ones, triggering VaR approach, incl. back and stresstesting.	None. Board of Directors must make assessment based on frequency and type of derivatives used and implement adequate RM method.	List of plain vanilla derivatives exist. Use of only those derivatives allows commitment approach. If only one non plain vanilla derivative is used, a more state of the art RM approach is required. As a basic principle, the qualified approach will be applied. The simplified approach can be used as an alternative if all market risks can be adequately detected and assessed.	N	None. Nature and frequency of derivatives will be used to assess RM method.	Distinction between A and B type UCITS (which triggers different RM approach) depending on number of complex derivatives.	Non-sophisticated UCITS are defined as UCITS with limited number of simple derivatives used for hedging or non-complex strategies.	None. Nature and frequency of derivatives will be used to assess RM method.	Extent of use of derivatives and/or use of complex strategies or instruments.	N	Funds using derivatives as part of their investment strategies are considered as sophisticated.	Several factors are taken into account, such as the use of derivatives as a fundamental part of fund’s investment objective, the performance of the derivative is non linear in relation to underlying, the performance is based on a reasonably complex mathematical formula.
Parameters of VAR approach	CI = 99% HP = 10 days HD = 1 year at least	CI = 99% HP = 1 month HD = 1 year max.	CI = 99% HP = 10 days HD = 1 year at least	CI = 99% HP = 10 days HD = 1 year at least	CI = 99% HP = 10 days HD = 1 year at least	CI = 95% HP = 7 days HD = none	CI = 99% HP = 1 month HD = 1 year at least	CI = 99% HP = 1 month HD = 1 year max.	CI = 99% HP = 1 month HD = 1 year at least	CI = 95% HP = 1 month HD = representative period	N	CI = 99% HP = 1 month HD = 1 year max.
VAR limits	Recommendation that absolute VaR limit should not exceed 30% of NAV.	N	200% of benchmark.	N	N	5% of NAV if absolute VaR with no reference benchmark (10% are possible with AMF special authorisation), otherwise twice the benchmark.	5% of NAV if absolute VaR with no reference benchmark, otherwise twice the benchmark.	N	20 % if absolute VaR with no reference benchmark, otherwise twice the benchmark.	N	N	N

CI = confidence interval HP = holding period HD = historical data

As one can see, not one country has really attempted to define what a “sophisticated” UCITS is. For some countries, the acid test in order to determine the appropriate Risk Management method is whether a certain number and type of “complex” derivatives are being used (Austria, France) or, on the contrary, whether one steps out of the boundaries of a “plain vanilla derivatives list” (Germany). Luxembourg has just issued a new circular on Risk Management to replace the existing 05/76, in

which the concept of “sophisticated” UCITS is quite broadly defined. This circular (07/308) clarifies the VaR parameters and provides a VaR limit.

However, one can see that internal Risk Management models (VaR) are applied throughout Europe, with more or less similar parameters.

3. Ancillary cash and deposits

With the inclusion of bank deposits as eligible assets for UCITS funds and a corresponding limitation of 20% of NAV by credit institution, the question has arisen as to how to treat ancillary cash, being money not meant for investment purposes but

resulting solely from subscriptions or used to fund immediate redemptions. Can that cash also be deposited with the same banking institute as the “deposits”? In other words, is the 20% counterparty limit also applicable to this “ancillary cash”?

	AT	BE	DE	DK	ES	FR	IR	IT	LU	NL	SW	UK
Does the 20% limit apply to “ancillary liquid cash”	Y	Y	Y	Y	Y	N	N	N	Y	Y	Y	Y

Interestingly, this question is not at all seen as a big issue by participants to our recent UCITS III review, even if as shown above, three countries apply the limit differently from the others. Some countries, like Italy and Ireland, also make a distinction depending on whether the cash and deposits are held at the custodian bank (in which case the 20% rule would not apply) or rather at another institution, in which case it would.

4. Management companies

UCITS III introduced the concept of management companies “with substance”, meaning entities with specific capital requirements, a need for qualified and reputable managers, internal controls and sound administrative procedures. These management companies see their activity as regards UCITS funds clearly defined (they are meant to do “Collective Portfolio Management” or “CPM”) and even extended, for those choosing to perform “Discretionary Portfolio Management” and ancillary, non-core activities. A “passport” to perform all of these existing or new services within the EU borders has been granted.

While already in place in certain countries (for example the German or Austrian “Kapitalanlagegesellschaften”, with

Whether this distinction was anticipated by the European lawmaker at the time of drafting the product directive is doubtful. However, it once again demonstrates the level of divergence in the interpretation of a relatively simple UCITS III rule.

a mandatory banking status and a share capital of 2.5 Mio EUR!) this was a more challenging adaptation for other European jurisdictions, among them Luxembourg and Ireland.

We have undertaken an update on the activities of management companies, the scope of their passport and of the way countries have chosen to implement parts of the new “substance requirements”.

The following chart provides an overview of the legal forms these management companies can take, their capital requirements and the types of funds (UCITS and non UCITS) they can manage, as foreseen by law and applied in common practice.

	AT	BE	DE	DK	ES	FR	IR	IT	LU	NL	SW	UK
Legal forms	Public limited company (AG) or private limited company (GmbH)	Public limited company (S.A.)	Public limited company (A.G.) or private limited company (GmbH)	Public limited liability company (“aktieselskab”)	Public limited liability company (S.A.)	Various forms: S.A., S.A.S., S.C.A., S.C.S., S.N.C., G.I.E.	Public limited or private limited company	Public limited company (Societa per Azioni)	S.A., S.à r.l., S.C.A., Société coopérative	NV or BV	Limited liability company (AB)	Limited liability company or partnership
Minimum capital requirements	2.5 Mio EUR + additional own funds (max. 7.5 Mio EUR) if AUM > 250 Mio EUR. Additional capital requirements if DPM services.	125,000 EUR + additional own funds if AUM > 250 Mio EUR. Additional capital requirements if DPM services.	730,000 EUR for non real estate KAGs + additional own funds if AUM > 3 Bio EUR or 2.5 Mio EUR if also manage real estate funds. Additional capital requirements if DPM services.	300,000 EUR + additional own funds if AUM above 250 Mio EUR or 1 Mio EUR if member of stock exchange, central security depository or clearing center. Additional capital requirements if DPM services.	300,000 EUR + additional own funds if AUM above threshold. Additional capital requirements if DPM services.	125,000 EUR + additional own funds if AUM > 250 Mio EUR. Additional capital requirements if DPM services.	125,000 EUR + additional own funds if AUM > 250 Mio EUR. Additional capital requirements if DPM services.	1,000,000 EUR + additional own funds if AUM > 250 Mio EUR. Additional capital requirements if DPM services.	125,000 EUR + additional own funds if AUM > 250 Mio EUR. Additional capital requirements if DPM services.	125,000 EUR + additional own funds if AUM > 250 Mio EUR. Additional capital requirements if DPM services.	125,000 EUR + additional own funds if AUM > 250 Mio EUR. Additional capital requirements if DPM services.	125,000 EUR + additional own funds if AUM > 250 Mio EUR. Additional capital requirements if DPM services.
Which funds can they manage?												
• Per law	UCITS + non UCITS (but no real estate funds)	UCITS + non UCITS	UCITS + non UCITS (but no real estate funds)	UCITS + non UCITS	UCITS + non UCITS	UCITS and non UCITS (in type 1 ManCos)	UCITS + non UCITS	UCITS + non UCITS	UCITS + non UCITS	UCITS + non UCITS	UCITS + non UCITS	UCITS + non UCITS
• In practice	UCITS + non UCITS Real estate funds usually managed by separate companies specialised in RE.	UCITS + non UCITS	Market players separate their activity between RE funds and other funds. While a KAG managing RE funds can also manage other non-UCITS or UCITS, this is generally not the case in practice.	UCITS + non UCITS	Real estate funds usually managed by separate companies specialised in RE.	UCITS and non UCITS (in type 1 ManCos)	UCITS + non UCITS	Generally the SpA specialise in securities funds (on the one side) and in real estate funds and non-UCITS, on the other side. Very few do all types of funds in the same structure. For hedge funds, the SpAs must be specialised.	UCITS + non UCITS	UCITS + non UCITS	UCITS + non UCITS	UCITS + non UCITS

We also wanted to investigate whether, similar to Luxembourg and Ireland, other EU countries would accept extended delegation arrangements.

It seems that all Member States have seized the opportunity offered by the Profession Directive and allowed the delegation of one or more of their functions to third parties, provided certain conditions are satisfied: the delegation cannot affect the management company's liability for the tasks delegated, it cannot generate conflicts of interests (e.g. if the asset management were delegated to the custodian) and it may not deprive the management company of the substance, thereby making it a letter-box entity.

Many countries do allow for an extensive delegation of central administration functions (fund accounting, NAV computation, register holding and TA function...), certain even abroad, but only the UK goes as far as allowing a full cross-border outsourcing of these tasks.

Asset management is often delegated by the management company to specialised asset managers, within or outside of the promoter's group. However, in some countries (Sweden, Spain, Denmark) such delegation of asset management remains essentially "national", while in others (Ireland, Luxembourg, Germany, Belgium) a cross-border delegation is the norm. Despite UCITS III rules on delegation, some countries (France, Italy) still cling to the principle of having "some"

5. Passporting of management companies

We all know that the full passport, allowing a management company to set up and manage a fund in a foreign domicile, has completely failed.

Nevertheless, if management companies cannot operate funds based in other member states, a growing number of management companies (principally major players) have created branches abroad to provide distribution, asset management or discretionary portfolio management services. This is certainly the case for the German KAG, which use their passport to service

6. Where do we go to now?

It's been a long and difficult road from UCITS I to UCITS III, a journey that has still not ended and that has proved frustrating and time consuming for the fund industry. The recent efforts of the EU Commission in proposing modifications to UCITS III are a testimony not to its failure (the brand remains a great global success, both in and outside of Europe), but to the need to eliminate difficulties to embrace evolution: of products, of distribution means and methods, and of investors expectations.

In this time of change, industry players and management companies also need to remain focussed on the provisions of the Market in Financial Instruments Directive (MiFID), which will impact them as from 1st November 2007.

asset management performed by the management company itself. For example, in France it would not be possible for a management company authorised to manage equity funds to fully delegate the management of such an asset class. In Italy, the management company must keep certain strategic investment decisions – stock picking can be delegated, but not the asset allocation. Interestingly, in both countries, the risk management function cannot be delegated abroad and must be undertaken locally, which is in sharp contrast to the prevailing situation in Luxembourg and Ireland.

The last element of CPM, i.e. "marketing", is generally delegated be it in the context of open-architecture distribution or to group distributors, and often outside of the fund's country of origin.

Discretionary portfolio management, the service inherited from the ISD and now available to management companies is performed by many German, Austrian, French and even quite a few Luxembourg UCITS III management companies. In all but one of the surveyed countries, the authorisation to provide DPM services also triggers the right to perform the "non-core" services mentioned by the Profession Directive, i.e. investment advice and safekeeping/administration of funds' shares. French "type 1" UCITS III Management Companies (those with a UCITS licence) can and even do perform non-core activities such as investment advice, without even being authorised to perform DPM services!

Luxembourg funds. French "sociétés de gestion" also use their passport when they provide asset management services to foreign funds.

Luxembourg management companies have passported themselves into Austria, France, Germany, Italy, Netherlands, Spain, Sweden, UK, either by creating branches or by using the "free provision of services" route. However, the passport is rarely for administration services.

MiFID applies directly to management companies that are authorised to provide MiFID services (DPM and investment advice) but it also affects distributors and financial intermediaries involved in the UCITS distribution chain.

It has become clear that there are numerous zones where MiFID and UCITS overlap, so that one may rightfully wonder which set of rules is applicable in different specific situations. CESR has made considerable efforts to make the Lamfalussy process effective on MiFID – harmonisation of rules among member states is a must.

Despite these efforts, some countries continue to dance to their own music, generally on topics where MiFID touches the funds and their distribution. For example, best execution requirements for the purchase of fund shares are to be excluded according to the German understanding of MiFID. This same country also exempts certain types of fund distributors from MiFID's scope, which will create some uncomfot for management companies using such distributors. Many relationships between a funds management company and its service providers, considered to be MiFID relationships all over Europe, are seen in Germany as CPM relationships and hence excluded from MiFID. Other countries, such as France or the UK, play the tune of convergence – MiFID rules are for all companies managing money, whether UCITS or MiFID firms.

In the context of single directional and complex legislative changes, EU harmonisation efforts will be extremely difficult and challenging for both regulators and industry players.

These remain interesting and complex times and as such the PwC UCITS III Champions Group remains committed to track the implementation status of MiFID as it relates to investment management over the next year or so and all the way through to UCITS IV!

You will hear from us again in the fall of 2007....

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