

***UCITS IV***  
What are the  
implications of the  
UCITS Management  
Company Passport?

Asset Management  
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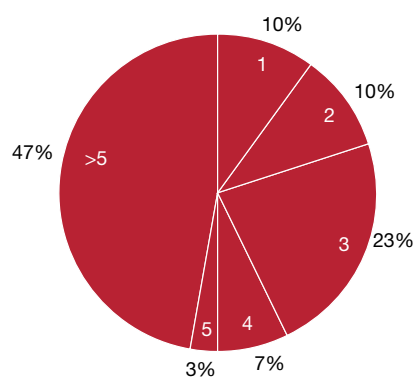
Under UCITS IV, UCITS Management Companies ('ManCos', or individually 'ManCo') will be allowed to set up and operate on a remote basis UCITS funds established in another EU Member State. In July 2010, the Commission's Level 2 Regulation (Regulation EU 583/2010) detailed the final measures related to the UCITS Management Company Passport ('MCP'). The new legislative framework will impact all European ManCos – even those which do not intend to make use of the passport.

## Background

### Consolidation needs

UCITS III did not resolve all the blockages related to the passport of ManCos. Thanks to UCITS IV, a compromise was found and the necessary framework for an effective passport has been implemented. The MCP should then facilitate the integration of the European fund market and at the same time should help to reduce costs of local management company structures.

#### Number of UCITS management companies domiciles per group



Source: Lipper – Top 30 cross-border group promoters – Figures end 2009

Indeed, at the end of 2009, 90% of the top 30 cross-border group promoters had at least two different countries of domicile for their UCITS funds. As a consequence, they also had several management companies ('ManCo') fulfilling resources and capital requirements. Out of this sample, 47% of the promoters had at least 6 ManCos in Europe!

However, rationalisation at ManCo level must take place in the context of a global strategic positioning of the fund organisation 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 rendered largely inefficient. The 2010 VAT package, 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 rationalisation is therefore a prerequisite.

## Scope of the UCITS IV MCP

The UCITS IV Directive applies to UCITS ManCos 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 will however change in the coming years since 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.

## 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 authorised.
- The law of the UCITS home Member State regulates the constitution and functioning of the UCITS, notably regarding the set-up and the authorisation process, the merger, the liquidation and the investment policies and limits, NAV errors / investment breaches, etc.
- The law of the home Member State of the ManCo regulates its organisation, including its ability to delegate its activities (in the same country or abroad), and 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

- Level 2 measures foresee the application of harmonised organisational and conduct of business rules to ManCos in order to facilitate the mutual recognition between European regulators in the context of the passport. The impact is therefore moderate in Member States where some of these rules directly derived from MiFID already apply to ManCos up to a certain extent.

### MiFID organisational rules (Governance)

- ManCos should set up independent compliance and internal audit functions. These functions can be delegated under certain conditions.
- ManCos should establish, implement and maintain effective procedures in relation to complaints handling, personal transactions and record keeping (portfolio transactions, subscription and redemption orders).
- Level 2 measures also 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 costs 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 the 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 the 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

- Inducements are seen as one of the main sources of conflicts of interests in the context of portfolio management and have received specific regulation.
- All payments (or non-monetary benefits) received or made in relation to the activities of investment management and administration to the UCITS must satisfy three conditions:
  - 1 They are adequately disclosed to the UCITS (and to the unit holders 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 the 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 for approving and monitoring periodically the general investment policy of the UCITS.
- ManCos should implement basic principles regarding the organisation of the accounting to ensure permanent identification of UCITS assets and 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 investors, 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.



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



The Committee of European Securities Regulators (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.

### Depositary

- The depositary 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 depositary.
- The content of the contractual arrangements to be in place between the ManCo and the depositary includes description of procedures related to safekeeping of assets, exchange of information, procedures following modification of UCITS rules, confidentiality obligations, prevention of money laundering, etc.
- However, the role and the responsibility of the UCITS depositary have not yet been harmonised at European level, and this might form the scope of a future UCITS V Directive.

### Risk management

- The distinction between sophisticated and non-sophisticated UCITS is abandoned. The labelling had been replaced by a selection of the most appropriate methods for market risk analysis based on the risk profile of the UCITS.
- The assessment of all risks and their materiality will be evaluated within the overall risk profile of the UCITS. Liquidity and operational risks are explicitly designated to be material.
- The global exposure (market risk) will need to be monitored on a daily basis.
- An initial validation of the VaR model will need to be performed by an independent third party.
- Leverage will need to be monitored independently from the method chosen for global exposure computation.
- The netting/hedging opportunities when using the commitment approach are more advanced and more specific.
- Back testing of VaR models must be performed on a monthly basis. Reporting to senior management should be done at least on a quarterly basis if the number of overshooting over the last year (250 business days) exceeds four.
- Counterparty risk is measured on the basis of the positive Mark-to-Market value of the contract (the add-on for future credit exposure will be abandoned). Initial margins posted to and variation margins receivable from brokers should be included in the computation of the counterparty limit.
- Disclosure requirements will increase for the prospectus and the financial statements (VaR levels, leverage, ...).
- 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).

## 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 transform 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 to locate in;
- Definition of management company organisation 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, etc.

### What are the critical business issues?

#### Interpretation of the proportionality principle?

A key challenge will be to reach compliance with MiFID organisational measures without taking unnecessary 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 third parties and distribution networks?

New organisational and conduct of business rules may 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 on their service providers additional and documented MiFID behaviour (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 inline with the transparency on charges in the KID and the RDR initiative of the UK.

#### What are the tax issues?

MCP may lead to situations where the only link with the country of domicile of the Fund is its incorporation (and supervision) in this country and therefore, where residence and management and control of the Fund can be challenged. This may imply major adverse tax consequences, notably the tax administration can challenge the UCITS residency and then deny the benefits of Double Tax Treaties! This could also lead to the taxation of the Fund in the country where key management decisions are actually taken, i.e. in the 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.

MCP allowing rationalisation/centralisation of the European management, existing management companies may be reorganised (liquidated, merged, migrated, etc...). In this respect, exit tax costs upon reorganisation will need to be considered as they can be significant and a proper tax analysis should be carried out to locate management activities in a country with competitive effective tax rates.

Last but not least, reorganisation and location decisions will become more critically important than ever for VAT purposes. Hence, the selection of the optimal solution for the (re)location will also need to be considered from a VAT perspective. As service flows become more and more international, it becomes increasingly easy to incur additional and often irrecoverable VAT costs. Considering the VAT implications as part of the reorganisation plan and (re)domiciliation decision may allow taking advantage of opportunities and mitigating VAT costs.

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