UCITS – An Operating Model For Tomorrow?

Europe's "Undertakings for Collective Investment in Transferable Securities" provides an example that Canada may want to follow.

Philip Niles
Butterfield Fulcrum

Almost unknown on our side of the Atlantic, UCITS have kicked around Europe in various forms for many years. In fact, 2011 is slated to mark the introduction of the fourth version of UCITS legislation (commonly referred to as UCITS IV) to the European investment community. Increasingly, investors ranging from smaller retail individuals to large institutions are turning to UCITS as sensible investment options. As they continue to gain momentum in Europe, it is likely time for North Americans to gain an understanding of precisely what UCITS are and what impact they may have going forward. Indeed, it may even be time for North Americans to consider a similar, more progressive approach like the one currently unfolding in the EU.

UCITS Defined and Discussed

Standing for *Undertakings for Collective Investment in Transferable Securities,* UCITS are effectively a directive that aims to allow collective investment funds to operate freely throughout the European Union after receiving approval from just a single member state. The idea is that, if a fund is investing in prescribed transferrable securities, the regulation of a fund manager by a single member state should be equivalent to regulation in all member states. Once the approval comes from the single member state, a fund is able to promote and sell their respective investment product throughout the EU, further promoting the EU's stated goal of a single, integrated market for financial services.

Though initially much of the potential of UCITS was dampened by various operational and political issues, subsequent revisions of UCITS legislation have enabled the original vision to become tangible. Investment managers are able to gain a "European Passport" which allows them to operate throughout the European Union freely. In addition, legislation has simplified the investment prospectus for funds and has also removed barriers on cross-border marketing, all while allowing a broader range of investment products within UCITS. Today, these collective investments feature strategies ranging from simple money market funds to more complex derivative funds; there are even index funds and fund of funds which are structured as UCITS.

Europe is already seeing tremendous popularity and growth in these products, both from the perspective of investors and managers. Investors are enjoying the opportunity to have access to a variety of collective investment programs which were previously unavailable due to jurisdictional restrictions. In addition, they are paying reduced fees because of the heightened cost-savings and greater competition. For investment managers, they are able to freely sell their investment product throughout the EU without the hassle of additional administrative burdens. Also, they are able to market to investors who were historically out of reach due to geographic limitations.

A report issued recently by RBC Dexia and KPMG perhaps best highlights the perceived benefits to fund managers. After surveying managers across the EU, 42% responded that the single greatest advantage in UCITS IV is cost savings. Additionally, 24% of respondents felt that easier access to new European Union markets was the high point. And though retail investors were not part of this survey, there is good news for them as well. A full 21% of fund managers felt that the greatest benefit of UCITS IV would be improved competitiveness of UCITS products. For investors, the connection is fairly plain: increased cost savings and heightened competition should mean lower fees; investment managers seem to be willing to exchange these lower fees for greater assets under management.

The Potential in North America

Certainly, North America could benefit from a structure similar to this, or at the very least could take some ideas from the European UCITS structure and consider their application. For example, in Canada, it is sometimes necessary for an investment manager to be registered in multiple provinces depending on their investor base and fund structure. The administrative onus on registered fund managers is typically quite high in just a single jurisdiction, but registration in multiple provinces with different regulatory bodies only heightens the filing burden. Additionally, different provinces have different standards with respect to hedge fund investment. As an example, Canadian jurisdictions have varying minimum investment requirements in hedge funds, ranging from $97,000 to $150,000 (AIMA Canada, 2009), which creates further differences across the provinces.

In truth, we could continue on ad nauseum discussing the differences among the provinces with respect to hedge fund administration, marketing, and management. What we're really driving at here is that Canada could hugely benefit from a single, harmonized directive which simplifies the administrative requirements of Canadian investment managers similar to that prescribed with respect to UCITS. In addition, the ability to market their products throughout Canada to a range of investors, regardless of their provincial domicile, would be a massive advantage for investment managers in pursuit of raising additional capital.

This concept could even, in theory, be adopted to include our neighbours to the south. Canada is blessed with a solid pool of talented, competent investment managers with stable operating histories and sophisticated operations. However, the relatively small size of the Canadian market leaves us in the shadow of the United States. It would be an enormous step in the right direction for Canadian fund managers if they could more easily market their funds to American investors. It would open up Canadian hedge funds to tens of billions of dollars in potential assets under management that were previously either unavailable or difficult to access. Enabling Canadian investment managers to access the vast investment capital of the United States would have a tremendous impact on our industry.

Truthfully, it might eventually come to the point where co-operation and co-ordination between Canada and the Unites States in this realm is not only prudent, but also necessary. As the European Union takes more and more steps towards a single market for financial services, North America may be forced to at least experiment with something similar in order to stay competitive. The declining expenses that UCITS IV promises will make investments in UCITS more attractive on a cost-adjusted basis. Though there will always be a high demand for outsized performance irrespective of fees, in theory UCITS could steal business from typical hedge funds based on cost alone. Similar cost-cutting directives in North America would ensure North American funds remained relatively competitive, at least from this perspective.

A Pipe Dream?

At the risk of extending this too far, the possibility could exist as well for the integration of European and North American markets as these segments mature. While there would always be differences between funds operating in Europe versus North America, co-operation between governing bodies could enable for even further cost savings as well as simplified administrative tasks. For instance, imagine an opportunity for investors anywhere in North America or Europe to invest without concern for regulatory hurdles or geographic barriers. More than ever before, investors would be able to achieve focused diversification without the typical barriers and target the fund managers they feel offer the best chance to meet their investment objectives, irrespective of nationality or domicile. In addition, investment managers would be free to market their fund to countless individual and institutional investors who they previously had no opportunity to access.

> As the European Union takes more and more steps towards a single market for financial services, North America may be forced to at least experiment with something similar in order to stay competitive.

Perhaps most notably, the potential of European and North American hedge fund markets to work together may be one of the best means to ensure prudent regulation rather than haphazard government intervention. It seems almost a foregone conclusion that, at some point in the future, heightened regulation will be a reality for investment managers. However, through proactive, international co-operation, the industry may be able to approach regulation on its own terms. The creation of a global, independent hedge fund regulatory body, based on regional collaboration, would remove the responsibility from governments and allow the industry itself to forge its own course. To be sure, the industry is some distance removed from this scenario, but over time the possibility is there.

Conclusion

The enhancements contained in UCITS IV are a major step forward for the integration of the European Union from a financial services perspective. Should the legislation pan out as intended, investors and fund managers should see lower operating costs, greater competition, and a more robust industry. While Europe accelerates down this prescribed path, some of the lessons seen in the UCITS doctrine could be applied to North American markets as well in order to enhance and further develop the current market environment. While it remains to be seen whether such changes are practical in Canada and the United States, a harmonized approach could offer tremendous benefits for both investors and fund managers. In addition, such collaboration and cross-border integration could help minimize industry regulation, or at the very least allow the industry to be able to have a say in regulation and pursue such a course in a sensible, self-governed way. *