

Soapbox

The financial crisis poses problems for Ucits products, writes Jon Brassey



The challenges facing Ucits

The publication in July of the European Commission's proposed revision to the legislative framework for Undertakings for Collective Investment in Transferable Securities (Ucits) marked another step on the road towards the completely free operation of collective investment schemes across the European Economic Area.

These amendments, known as Ucits IV, are the latest in a series of changes to Ucits since wider investment powers were conferred upon managers by the Product Directive in 2001. However, while Ucits products have become increasingly popular and form a vital part of the financial sector, a number of threats could stymie their continued development, including the current financial turmoil, which may well have an impact on the legislation. As the investment industry awaits the response of the European Parliament to the proposed changes, many participants in the sector are contemplating what challenges the future holds for providers of Ucits.

Controversially omitted from the proposals are provisions for the so-called 'management company passport'. These provisions would have

enabled fund managers to remotely manage funds which are domiciled in other European Economic Area member states. The Committee of European Securities Regulators (CESR) has issued a call for evidence on the Ucits assets management company passport, and will submit advice to the European Commission in early November. It now remains to be seen what supervisory and technical conditions CESR may recommend.

Since July, market dynamics have changed radically, which will have implications for prospective Ucits legislation. Complex asset classes, which have become eligible for inclusion in Ucits funds, will not disappear from those funds overnight. But there will be valuation difficulties associated with certain derivatives instruments. Any exposure to structured products will necessitate a review of funds' risk profile.

The financial crisis has highlighted liquidity issues facing Ucits funds, which are obliged to take into account their own liquidity requirements in order to be able to meet redemption requests from shareholders at any time. Ucits funds have quite onerous investment restrictions, but this has begun to change with the clarification of the full potential of Ucits by the Eligible Assets Directive. Ucits can now invest in standalone financial derivative instruments, gaining exposure to a variety of new asset classes, such as hedge fund indices and commodity indices.

Sophisticated Ucits that are distributed to retail investors must have an adequate risk profile. Although regulators have allowed diverse equity derivatives products to be included in Ucits wrappers, Markets in Financial Instruments Directive (MiFID) has increased the requirements regarding the suitability of the product sold to a particular investor. So, the public offering of alternative strategy Ucits requires reasonable market segmentation in order to limit reputational and regulatory risks. In particular, arrangers and distributors of a

product are required to provide an adequate explanation of the risks underlying the relevant structure. Concerns have been raised in the industry that the greater risk management and regulatory work required for structuring Ucits products will lead to new products taking much more time to develop.

One of the principal drivers for change in the Ucits industry is its growing institutional investor base. Faced with the current challenges accompanying the credit crunch, institutional investors have increasingly targeted Ucits funds as an opportunity to enhance their investments' yields, while diversifying their strategy and investment managers. Ucits products which can replicate alternative strategies will offer investors the opportunity to take advantage of potentially greater returns than traditional investments, while remaining within the protective cocoon of the Ucits framework.

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It is likely to be only a matter of time before the fund management industry and investment banks active in the market make attempts to launch another wave of innovation. Expectations are that such developments will result in more sophisticated strategies and an increasing use of structured products in the funds environment. The hope is that regulators will continue to allow the European funds industry to grow by supporting innovation and facilitating the creation of new products, while retaining appropriate regulations.

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