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Jumping the Gun: Hedge Funds in Search of Capital Under UCITS IV

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INTRODUCTION

An undertaking for collective investment in transferable securities (UCITS)[1] is a regulated investment scheme that complies with the UCITS Directive (UCITS I), as first enacted by the European Economic Community (EEC) in 1985,[2] and its subsequent amendments (the UCITS Directives).[3] In its current form, a UCITS fund[4] has been described as a mutual fund that may employ certain hedge fund strategies.[5] UCITS funds have been called everything from a "poor man's hedge fund"[6] or "hedge fund lite,"[7] to a "badge of quality"[8] or even the "gold standard"[9] of investor protection. A UCITS fund offers "the best of both worlds,"[10] in providing hedge fund-like investments and significant regulatory oversight, which has made them the "primary investment method for retail investors throughout [Europe]."[11] This investment flexibility, accompanied by significant investor protection, is largely what the drafters of UCITS I envisioned when they sought to facilitate the cross-border offering of investment funds to retail investors, develop an integrated and competitive single European market for investment funds, and establish a uniform level of investor protection.[12]

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1. Pronounced yoo-sits. *Undertakings for Collective Investments in Transferable Securities*, WIKIPEDIA, http://en.wikipedia.org/wiki/UCITS (last visited Mar. 12, 2010).

2. *See* Council Directive 85/611, 1985 O.J. (L 375) (EEC) [hereinafter Council Directive 85/611]; Albert Francke, III, *Capital Flows between Countries: Reciprocal Arrangements for the Sale of Shares in Mutual Funds*, 1987 COLUM. B. L. REV. 365, 366.

3. The UCITS Directives are "not law applicable to funds, but are part of the treaty apparatus that constitutes the [European Union (EU)]" whereby Member States are required to implement these directives at the "national level" within certain parameters. John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 1 J. LEGAL ANAL. 591, 647 n.103 (2009).

4. Although the term "UCITS fund" renders the word "fund" redundant, as the word "undertaking" implies a certain investment vehicle, the concept is easier to grasp with this redundancy intact.

5. Dustin Hawks, Note, *Long-Term Capital Gain: The Regulatory Landscape for Hedge Funds after* Goldstein, 27 J.L. & COM. 171, 190 (2008).

6. Harriet Agnew, *UCITS Interest Grows*, ABSOLUTE RETURN + ALPHA, Dec. 15, 2008, http://www.absolutereturn-alpha.com/Article/2068537/Search/Ucits-Interest-Grows.html?Keywords=UCITS+Interest+Grows.

7. Peter Guest, *A Long/Short Answer to Risk Gains Popularity*, FIN. TIMES (London), Mar. 2, 2008, at 16.

8. Agnew, *supra* note 6.

9. Grellan O'Kelley, *UCITS Funds Gain Popularity, Increasingly Employ Hedge Fund Strategies*, FINALTERNATIVES (Sept. 1, 2009), http://www.finalternatives.com/node/8961.

10. George Sami, Comment, *A Comparative Analysis of Hedge Fund Regulation in the United States and Europe*, 29 NW. J. INT'L L. & BUS. 275, 301 (2009).

11. *See* Michael J. Schmidt, Note, *"Investor Protection" in Europe and the United States: Impacting the Future of Hedge Funds*, 25 WIS. INT'L L.J. 161, 178 (2007).

12. *See* Francke, *supra* note 2, at 366.

UCITS funds follow the "common minimum standards"[13] of the UCITS Directives and may be "freely marketed on a cross-border basis . . . in accordance with [a] single passport principle."[14] Legislative enactments have subsequently amended UCITS I[15] through the "Management Directive"[16] and the "Product Directive,"[17] which were passed in 2001,[18] and together formed UCITS III.[19] While UCITS funds utilize a limited set of eligible assets and strategies like mutual funds,[20] subsequent amendments have permitted UCITS fund managers to employ sophisticated hedge fund strategies, traditionally outside the purview of mutual funds.[21] The most recent amendment is UCITS IV,[22] which was proposed in July 2008 and will come into effect in mid-2011.[23]

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13. *Id.* (explaining how Member States may exceed certain threshold requirements set at the EU level, but may not drop below the threshold). Such minimum "harmonization" requirements relate to "organization, management, oversight, fund diversification, liquidity, use of leverage, and eligible assets." Elizabeth Grace et al., *Financial Products and Services Committee*, 42 INT'L LAW. 565, 572 (2008).

14. Jarkko Syyrila, *Regulators' Dilemma: Hedge Funds for the Public?*, 18 J. INT'L BANKING L. & REG. 95, 97 (2003).

15. Paulina Dejmek, *The EU Internal Market for Financial Services—A Look at the First Regulatory Reponses to the Financial Crisis and a View to the Future*, 15 COLUM. J. EUR. L. 455, 472 (2009).

16. David Rouch & Katherine Smith, *The UCITS Directive and the Single European Funds Market: A Case Review*, 20 J. INT'L BANKING L. & REG. 251, 252 (2005); Council Directive 2001/107, 2002 O.J. (L 41) 20 (EC) [hereinafter Council Directive 2001/107]. The Management Directive regulates management companies and the simplified prospectus. Council Directive 2001/107, *supra.*

17. Rouch & Smith, *supra* note 16, at 252; Council Directive 2001/108, 2002 O.J. (L 41) 35 (EC) [hereinafter Council Directive 2001/108]. The Product Directive regulates investments by UCITS funds. Council Directive 2001/108, *supra*.

18. David A. Kanarek, *Directive 2001/107/EC on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS) with a View to Regulating Management Companies and Simplified Prospectuses*, 8 COLUM. J. EUR. L. 557, 557–58 (2002).

19. Rouch & Smith, *supra* note 16, at 252. UCITS II was a reform measure that was never implemented. *See* Ashley Kovas, *UCITS—Past, Present and Future in a World of Increasing Product Diversity* 11 n.35 (Inst. for Law and Fin., Working Paper No. 44, 2006), *available at* http://ilf-frankfurt.org/uploads/media/ILF_WP_044.pdf.

20. Mutual funds "may be more or less restrictive on any given issue" when compared to UCITS. Patrick J. Paul, Note, *The European Community's UCITS Directive: One Model for United States Regulatory Change in a Globalized Securities Market*, 25 VAND. J. TRANSNAT'L L. 61, 86 (1992) (quoting Request for Comments on Reform of the Regulation of Investment Companies, 55 Fed. Reg. 25,322, 25,326 (June 21, 1990) (to be codified at 17 C.F.R. pt. 270) (internal quotes omitted)).

21. *See* Hawks, *supra* note 5, at 190.

22. Council Directive 2009/65, 2009 O.J. (L 302) 32 (EC) [hereinafter Council Directive 2009/65].

23. Karen L. Anderberg & Jessica Brescia, *UCITS and Cross-Border Registration: The Scheme Has Expanded Beyond Europe*, THE HEDGE FUND J., July 2009, *available at* http://www.thehedgefundjournal.com/magazine/200907/technical/ucits-and-cross-border-registration.php.

UCITS funds have become "[an EU] success story and global brand,"[24] accounting for 75% of assets under management within Europe's fund industry and over €6 trillion in assets as of the second quarter of 2009.[25] Juxtaposed to this success, total global hedge fund assets fell by almost a third during the second half of 2008,[26] due to both investor redemptions and losses.[27] Consequently, hedge fund managers have been in search of a means to replenish these assets.[28] Many of these managers see a UCITS "wrapper"[29] as a solution.[30]

The UCITS structure presents an opportunity for hedge funds to solicit both retail and institutional investors on a cross-border basis, thus broadening their investor bases and the availability of assets.[31] Investors are likewise seeking out UCITS funds[32] because of their reputation for greater transparency and liquidity than traditional hedge funds,[33] which saw massive redemptions after Bernard Madoff's $65 billion Ponzi scheme was brought to light at the end of 2008.[34] Additionally, the European Commission's (EC's) initial draft of the Directive on Alternative

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24. Dejmek, *supra* note 15, at 472.

25. EUROPEAN FUND AND ASSET MGMT. ASS'N, TRENDS IN THE EUROPEAN INVESTMENT FUND INDUSTRY IN THE SECOND QUARTER OF 2009, at 8 (2009), http://www.efama.org/index.php?option=com_docman&task=doc_download&gid=1033.

26. Richard Ernesti & William Potts, *Hedge Funds Turn to the UCITS Kitemark*, HEDGEWEEK (Sept. 9, 2009), http://www.hedgeweek.com/2009/09/09/hedge-funds-turn-ucits-kitemark.

27. Saijel Kishan, *Hedge-Fund Investors Remove Record $152 Billion*, BLOOMBERG, Jan. 21, 2009, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=aL3fOSkanqs8; Tomoko Yamazaki, *Hedge Funds Post Record $350 Billion Loss in 2008*, BLOOMBERG, Jan. 14, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ahzEW2I3AhP8#.

28. *See* Ernesti & Potts, *supra* note 26.

29. Bryan Goh, *UCITS III: The Opportunity*, HEDGED.BIZ (Nov. 9, 2009, 4:35 PM), http://hedged.biz/index.php?option=com_content&view=article&id=202:ucits-iii-the-opportunity&catid=1:latest-news&Itemid=63 (explaining how certain hedge funds may be able to offer the same product in a different "wrapper" by being UCITS compliant).

30. *See* Ernesti & Potts, *supra* note 26.

31. *See id.* One of the first hedge fund managers to launch a UCITS III fund was RWC Partners in 2006. Steve Johnson, *UCITS Pioneer in the Hedge Fund World Warns of Glut*, FIN. TIMES (London), Aug. 23, 2010, at 4.

32. During August 2009, "[i]nflows into UCITS funds amounted to €36 billion." Joel Schoppig, *UCITS Funds See €36 bn Inflows in a Month*, CITYWIRE (Oct. 14, 2009, 1:01 PM), http://www.citywire.co.uk/selector/-/news/other/content.aspx?ID=361760.

33. *See* Syyrila, *supra* note 14, at 97–98. During periods of exceptional market stress, liquidity may not be a guarantee just by virtue of initially being UCITS compliant. *See* ADVENT, UCITS COME TO THE FORE: OPPORTUNITIES AND CHALLENGES FOR THE FUNDS INDUSTRY 6 (2010), *available at* http://www.advent.com/collateral/wp_ucits.pdf.

34. *See* Phil Wahba, *Hedge Fund Industry Still Feeling Madoff Effect*, REUTERS, Mar. 26, 2009, http://www.reuters.com/article/PrivateEquityandHedgeFunds09/idUSN2544322520090326?pageNumber=1 (explaining the negative effect of the Madoff scandal on the hedge fund industry). *But see* Stephanie Bodoni, *Luxembourg Seeks Closure of Third Madoff-Linked Fund (Update 2)*, BLOOMBERG, Mar. 3, 2009, http://www.bloomberg.com/apps/news?pid=conewsstory&refer=conews&tkr=UBS%3AUS&sid=a6tXFEXnxUww (explaining how Madoff-linked UCITS funds—not hedge funds—had to be liquidated by Luxembourg's financial regulator).

Investment Fund Managers (AIFM Directive)[35] may have motivated hedge fund managers in the EU and the U.S. to seek compliance under UCITS,[36] rather than face potentially onerous restrictions.[37] That said, it is expected that 1,000 hedge funds with over $150 billion in assets under management—including many leading names in the industry[38]—will have made the transition to UCITS III-compliance by the end of 2010.[39] Some are even predicting that the current hedge fund industry will "mostly disappear" with the launch of these "newcits."[40]

Despite the recent flood of hedge funds transitioning to the UCITS brand,[41] this conversion may be premature given the realities of UCITS IV, in its current form.[42] Significant up-front and on-going costs will continue to be associated with running a UCITS IV-compliant fund, despite the professed benefits.[43] Further, the specter of registration under the AIFM Directive in the EU and hedge fund registration under Dodd-Frank in the

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35. *See Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/ . . . /EC*, COM (2009) 207 final (Apr. 30, 2009) [hereinafter *Initial AIFM Directive Proposal*]. The initial draft of the AIFM Directive imposed heightened restrictions on alternative funds that are not UCITS funds, which included hedge funds and private equity funds, while offering some of these funds a marketing passport throughout Europe. *See* Simon Thomas & Samuel T. Brooks, *European Alternative Funds: The Alternatives*, THE HEDGE FUND LAW REP., June 24, 2009, http://www.hflawreport.com/issue/72 (follow "European Alternative Funds: The Alternatives" hyperlink).

36. *See* Sam Jones, *Funds in Effort to Trump Rules with UCITS Roll-Out*, FIN. TIMES (London), Sept. 11, 2009, at 13; Thomas & Brooks, *supra* note 35; *How Asian Funds Will Avoid EU Directive*, INT'L FIN. L. REV., Sept. 1, 2009, *available at* http://www.iflr.com/Article/2282895/How-Asian-funds-will-avoid-EU-directive.html.

37. Some of the restrictions relate to: marketing, capitalization, operations, disclosure and reporting, investment, valuation protocols, and custody of fund assets. Press Release, Europa, Directive on Alternative Investment Fund Managers (AIFMs): Frequently Asked Questions (Apr. 29, 2009), http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/211&format=HTML&aged=0&language=EN&guiLanguage=en [hereinafter Europa Press Release].

38. A non-exhaustive list of hedge fund managers forming UCITS funds includes RAB Capital, Man Group, Thames River, Marshall Wace, Blackrock, Schroders, Pimco, 3A, Collins Stewart Fund Management, and HSBC. Steve Johnson, *Fund of Funds Dive into Hedgie UCITS Pool*, FIN. TIMES (London), Nov. 16, 2009, at 3.

39. EUREKAHEDGE, THE EUREKAHEDGE REPORT: SEPTEMBER 2010, at 34 (2010), http://www.eurekahedge.com/news/EHReport_tracker.asp?File=21092010_EH_Report.pdf.

40. Angus Foote, *Corsaletti Sees 'Newcits' Bringing Radical Change to Hedge Fund Sector*, CITYWIRE (Dec. 7, 2009), http://www.citywire.co.uk/selector/-/news/selectors-choice/content.aspx?ID=371477. *But see* Divya Guha, *Analysis Must Change to Deal with 'Newcits' Funds, Say Selectors*, CITYWIRE (Nov. 19, 2009), http://www.citywire.co.uk/selector/-/news/comment/content.aspx?ID=368669 (explaining that 85% of selectors do not believe "newcits" funds will replace both traditional long-only and hedge funds).

41. *See* Michael S. Fischer, *The UCITS States of America*, HFMWEEK (Oct. 15, 2009), http://www.hfmweek.com/articles/homepage/comment-and-analysis/262132/the-ucits-states-of-america.thtml.

42. *See* Marco Lamandini, The Commission's UCITS IV Proposal: Is It Sufficient to Create a True Single Market Platform? 1–2 (unpublished manuscript) (Sept. 4, 2008), *available at* http://works.bepress.com/cgi/viewcontent.cgi?article=1013&context=marco_lamandini.

43. *See* Fischer, *supra* note 41; Lamandini, *supra* note 42, at 15.

U.S. may partially explain why hedge funds have nevertheless sought out UCITS-compliance.[44] While the benefits of UCITS IV are potentially tangible—as evidenced by this recent interest—UCITS IV must be amended in order to realistically achieve a fully integrated and efficient investment fund market in Europe. Part I of this note will examine the UCITS I and UCITS III regimes[45] through the Management and Product Directives, as they provide the foundation for UCITS IV. Part II will explore the amendments comprising UCITS IV. Part III will examine the costs and benefits associated with UCITS-compliance and the influence of EU and U.S. hedge fund registration proposals on fund managers seeking UCITS-compliance. Part IV will suggest possible amendments to UCITS IV so that its benefits are more firmly within reach.

I. QUITE AN UNDERTAKING: UCITS I THROUGH UCITS III

A. UCITS I

UCITS I must first be discussed to provide the necessary groundwork for understanding UCITS III.[46] UCITS I took effect on October 1, 1989[47] by establishing "common minimum standards for the authorization and operation of UCITS" so as to meet the twin goals of ensuring regulatory harmonization and maintaining adequate investor protection.[48] It is important to emphasize that UCITS I set forth minimum standards, over which Member States could impose stricter requirements.[49] These minimum standards related to the structure of UCITS funds, the eligible assets in which UCITS funds could invest, and the extent to which authorization in a Home Member State could be "passported"[50] to a Host Member State.[51] However, part of the failure of UCITS I was that individual Member States did, in fact, impose stricter requirements, which led to "drastically varied" regulation across Member States, frustrating harmonization.[52]

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44. Simon Gray, *Milestones on the Road to Recovery*, HEDGEWEEK (Mar. 17, 2009), http://www.hedgeweek.com/2011/03/17/110206/milestones-road-recovery.

45. As previously mentioned, UCITS II was never implemented and, therefore, will not be discussed. *See* Kovas, *supra* note 19, at 11 n.35.

46. While UCITS I has been subsequently amended by further directives, provisions of UCITS I that have not been directly revised remain in force.

47. Allan S. Mostoff, *Organizing and Marketing Undertaking for Collective Investment in Transferable Securities (UCITS)*, 824 PLI/CORP 131, 133–34 (1993).

48. Francke, *supra* note 2, at 366.

49. *Id.*

50. Anderberg & Brescia, *supra* note 23.

51. A UCITS fund is subject to the supervision of the EU Member State in which it is domiciled—its Home Member State; authorization from that Home Member State is supposed to be sufficient to obtain authorization in a different Member State, i.e. passporting authorization. *See* Lamandini, *supra* note 42, at 4.

52. *See* David T. Schubauer, Note, *The Inadequacy of the UCITS Directive in a Global Marketplace*, 21 N.Y.L. SCH. J. INT'L & COMP. L. 323, 324 (2002). Ironically, it was initially

Although a UCITS fund may pursue a wide range of strategies in various legal forms,[53] all UCITS funds must comply with certain restrictions.[54] Under UCITS I, funds had to be open-ended structures whose sole object was to invest in transferable securities or other liquid assets.[55] Additionally, a UCITS fund had to—and still must—"repurchase or redeem its units at the request of any unit-holder"[56] and publish the price at which they were redeemed at least twice a month.[57] As a result, funds could invest no more than 10% of their assets in certain illiquid transferable or debt securities,[58] no more than 5% in other UCITS funds, and no assets in non-UCITS.[59] Such limits prevented UCITS funds from creating portfolios that were disproportionately composed of illiquid securities, which would make on-demand investor redemption difficult.[60] UCITS I also imposed diversification limits,[61] as well as borrowing and lending limits.[62] However, these restrictions prevented UCITS fund managers from operating with sufficient flexibility to seize certain investment opportunities.[63]

Despite the aforementioned restrictions, the passporting of authorization is the carrot that justifies the stick. In theory, when a Home Member State authorizes a UCITS fund to operate in that particular country, the authorization is valid for all other Member States through a notification procedure, which allows that UCITS fund to market its shares to the public in a Host Member State[64] after just two months.[65] However, under UCITS I, a Host Member State's regulator could deny authorization for cause (subject to judicial review).[66] Additionally, as UCITS I did not cover distribution activities concerning advertisement, listing, and sales

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speculated as unlikely that member countries would "ever go beyond the minimum standards of the directive" due to concerns of competitive advantage. Francke, *supra* note 2, at 366.

53. UCITS funds may be structured in various legal forms, including common funds managed by management companies, as unit trusts, or as investment companies. Council Directive 85/611, *supra* note 2, art. 1(3).

54. *See* Council Directive 85/611, *supra* note 2.

55. *Id.* art. 19.

56. *Id.* art. 37(1).

57. *Id.* art. 34. Although Member States may reduce the frequency of redemptions to once a month in certain cases. *Id.*

58. *Id.* art. 19(2)–(3).

59. *Id.* art. 24(1)–(2).

60. *See* Goh, *supra* note 29.

61. A fund could not invest more than 5% of its assets in a single security. Council Directive 85/611, *supra* note 2, art. 22(1). This requirement allowed UCITS funds to operate within the principle of risk spreading. *See id.* art. 1(3); Schubauer, *supra* note 52, at 328–29 (explaining that the 5% limit encourages diversification to limit a fund's exposure to risk).

62. Funds could not borrow more than 15% of their assets on a temporary basis, and conversely, could not grant loans or act as guarantor on behalf of third parties. Council Directive 85/611, *supra* note 2, arts. 36(2), 41(1).

63. *See* Rouch & Smith, *supra* note 16, at 252 (discussing how UCITS III "extended" the investment powers and versatility of UCITS funds).

64. *See* Schubauer, *supra* note 52, at 327–28.

65. Council Directive 85/611, *supra* note 2, art. 46.

66. *See id.* art. 51.

practices,[67] individual Member States disjointedly regulated these activities.[68] It is this type of supplemental regulation that prevented full integration under UCITS I and left only a "small number of funds"[69] capable of taking the "cross-border plunge."[70]

Tied to the authorization process, UCITS I required comprehensive disclosure requirements aimed at ensuring investor protection.[71] These disclosure requirements took the form of a prospectus and both annual and semi-annual reports.[72] Under UCITS I, the prospectus specifically required a minimum set of information "necessary for investors to be able to make an informed judgement of the investment proposed to them,"[73] which had to be kept up to date.[74] In addition to the annual and semi-annual reports, the prospectus had to be forwarded to a Host Member State for authorization purposes with an "attestation" of authorization from the Home Member State and the fund's organizing documents.[75] Although UCITS I laid the necessary framework for a unified collective investment market and a uniform level of investor protection, the goal of full integration was slow to be realized.[76]

B. UCITS III: MANAGEMENT DIRECTIVE

In order to further promote the cross-border sale of UCITS funds and modernize UCITS funds' investment choices, the EC passed the Management Directive and the Product Directive in 2001.[77] The Management Directive sought to remedy the balkanization of the UCITS fund industry by: (1) expanding management company activities; (2) equalizing competition; and (3) requiring the publication of a "simplified prospectus in addition to the full prospectus."[78] The simplified prospectus

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67. *See* William C. Philbrick, *The Task of Regulating Investment Funds in the Formerly Centrally Planned Economies*, 8 EMORY INT'L L. REV. 539, 574 n.157 (1994); Council Directive 85/611, *supra* note 2, art. 44. Similarly, subsequent directives do not regulate distribution activities. *See* Council Directive 2001/107, *supra* note 16; Council Directive 2007/16, 2007 O.J. (L 79/11) (EC) [hereinafter Council Directive 2007/16]; Council Directive 2009/65, *supra* note 22.

68. *See* Philbrick, *supra* note 67, at 574.

69. *See* Schubauer, *supra* note 52, at 329.

70. Liam Mulloy, Letter to the Editor, *Old Taxation Habits Die Hard*, FIN. TIMES (London), Jan. 11, 1991, at 17.

71. *See* O'Kelley, *supra* note 9.

72. Council Directive 85/611, *supra* note 2, art. 27.

73. *Id.* art. 28(1).

74. *Id.* art. 30.

75. *Id.* art. 46.

76. Lamandini, *supra* note 42, at 5.

77. *See* Robert W. Helm & Kevin K. Babikian, *Creating, Managing and Distributing Offshore Investment Products: A Legal Perspective*, *in* NUTS AND BOLTS OF FINANCIAL PRODUCTS 2006: UNDERSTANDING THE EVOLVING WORLD OF CAPITAL MARKET & INVESTMENT MANAGEMENT PRODUCTS 675, 858–60 (PLI Corp. L. & Prac., Course Handbook Ser. No. 8392) (2006).

78. Kanarek, *supra* note 18, at 558.

was a major change that aimed to provide the average investor with clear, concise information[79] necessary to make an informed investment decision, in contrast with the long, confusing prospectus utilized under UCITS I.[80] While the simplified prospectus had to be published alongside the full prospectus[81] in the official language of the Host Member State or in a language approved by the Host Member State,[82] fund managers only had to provide the full prospectus, annual report, and semi-annual report upon request.[83] However, despite the simplified prospectus being a "maximum harmonisation"[84] document, it eventually became apparent that the simplified prospectus was not simplified enough.[85]

While the Management Directive arguably made the prospectus more investor-friendly, it failed to address the sluggish passporting process, which acted as a barrier to entry for UCITS funds.[86] The continued inefficiency of the passporting process can be partially attributed to the wide variation of extraneous information required by different Member States, beyond that specified under UCITS I.[87] As a result, the cross-border registration of UCITS funds remained a costly and time-consuming process, both in obtaining initial authorization and operating on an ongoing basis.[88] With uncertainty as to when a fund would be able to begin operating, many funds failed to venture out of their Home Member States,[89] partly contributing to a high concentration of UCITS funds in Luxembourg, Ireland, and the United Kingdom.[90]

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79. The contents of the simplified prospectus included: "a brief presentation of the UCITS," "investment information," economic information regarding taxation, fees and expenses, and commercial information detailing the manner in which its units can be bought and sold. Council Directive 2001/107, *supra* note 16, at Annex 1: Schedule C; Helm & Babikian, *supra* note 77, at 864.

80. Schubauer, *supra* note 52, at 332.

81. Council Directive 2001/107, *supra* note 16, art. 27(1).

82. *Id.* art. 47.

83. *Id.* art. 33(1).

84. *See* Rouch & Smith, *supra* note 16, at 258 (explaining how individual Member States could not impose stricter regulations than those at the EU level).

85. *See id.*

86. *See id.*

87. *See id.*; *see also* Council Directive 85/611, *supra* note 2, art. 44.

88. *See* Rouch & Smith, *supra* note 16, at 257 (explaining that the two-month approval period was a soft-deadline in practice).

89. *See* Lamandini, *supra* note 42, at 6.

90. *See id. But see* Rouch & Smith, *supra* note 16, at 259 (explaining how the high concentration of UCITS funds in certain countries can also be attributed to the fact that depositaries must be located in the same Member State as the fund appointing it without an equivalent passport); Lamandini, *supra* note 42, at 6 (explaining how high concentrations in these particular countries can be partially attributed to beneficial tax rates and robust domestic retail markets).

C. UCITS III: PRODUCT DIRECTIVE

The EC adopted the Product Directive in 2002[91] to give UCITS funds investment flexibility to adapt to changing markets while still protecting investors.[92] Though the Product Directive permitted a UCITS fund to operate with a "higher degree of volatility and complexity" than was possible under UCITS I, the use of "advanced" investment strategies allowed these funds to hedge their risks to the benefit of investors.[93] Significantly, this directive amended the list of eligible assets[94] by allowing UCITS funds to invest in money market instruments, bank deposits, funds of funds, standardized financial futures, options traded on regulated markets,[95] and replications of stock index compositions.[96] Under this directive, financial derivatives could be used for investment purposes and not just for efficient portfolio management, as under UCITS I;[97] however, leverage was capped at 100% of the fund's value.[98] The Product Directive also increased the limit on investing a fund's assets within the same body to 20%[99] and investments in non-UCITS to 30%.[100] Importantly, the directive also required each manager to employ a "risk-management process."[101] These changes were helpful in updating UCITS funds for the new century,[102] but given the ever-changing nature of the finance industry and the passage of time,[103] the Product Directive inevitably had to be updated.

That update came through the Eligible Assets Directive,[104] which clarified the investment powers described in the Products Directive.[105]

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91. Council Directive 2001/108, *supra* note 17.

92. *See* Schubauer, *supra* note 52, at 330–31.

93. *See* Simon Dodds, *Current Regulatory Issues: Selected Materials*, 1580 PLI/CORP 109, 198 (2007).

94. *See* Council Directive 85/611, *supra* note 2, art. 19(1).

95. Council Directive 2001/108, *supra* note 17; Schubauer, *supra* note 52, at 330–31.

96. Council Directive 2001/108, *supra* note 17, art. 22(a).

97. Rouch & Smith, *supra* note 16, at 254. Additionally, there had to be a process in place for ensuring the "accurate and independent valuation of OTC derivatives." *Id.* at 255.

98. *See id.* at 255; Council Directive 2001/108, *supra* note 17, art. 21(3).

99. Council Directive 2001/108, *supra* note 17, art. 22(1).

100. *Id.* art. 24(2).

101. *Id.* art. 21.

102. Rouch & Smith, *supra* note 16, at 252.

103. *See* Dejmek, *supra* note 15, at 473–74 (hypothesizing that a "new approach" to future legislation may be worth considering as "an increasing number of funds already fall outside the scope" of the UCITS framework given the continuing development of financial products and investment vehicles).

104. Council Directive 2007/16, *supra* note 67.

105. This directive was the first of the UCITS Directives to be implemented under the Lamfalussy regime. *See* Dejmek, *supra* note 15, at 462–64. The Lamfalussy regime seeks to "streamline and accelerate" European securities legislation by establishing a committee system involving the Committee of European Securities Regulators (CESR) and the European Securities Committee (ESC) to assist in the refinement of legislation through multiple levels of review. *See* Rouch & Smith, *supra* note 16, at 252; *see also* Dejmek, *supra* note 15, at 462–63 (explaining that the Lamfalussy framework is a four-level structure of legislative review: (1) "basic legislative framework adopted by []legislators"; (2) "comitology committee" approval by representatives

Under the Eligible Assets Directive, closed-end funds were considered eligible assets under certain conditions.[106] Asset-backed securities, Euro Commercial Paper, index-based derivatives, and credit derivatives were also added.[107] The Product Directive, in conjunction with the Eligible Assets Directive, updated the UCITS regime to remain competitive, yet certain limitations on products inevitably prevented UCITS from changing with the times.[108]

II. ONE SMALL STEP, INSTEAD OF A GIANT LEAP: UCITS IV

A. THE ORIGINS OF UCITS IV

Although UCITS III constituted a significant step forward for the operation and harmonization of UCITS funds within Europe, it fell short in a number of ways.[109] UCITS III resulted in national markets "dominated" by local funds without full integration.[110] In fact, only three countries—Luxembourg, Ireland, and the United Kingdom—have been able to market their funds to at least two-thirds of all Member States, leaving most countries with limited product choice and a relatively closed national market.[111] Pursuant to these shortcomings, UCITS IV grew out of a number of evaluations over the efficacy of UCITS III,[112] after which the EC concluded that five areas needed to be addressed in order to improve UCITS III: (1) notification procedures to the Host Member State's

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from all Member States; (3) CESR supplying technical advice to the EC on securities-related measures; and (4) monitoring the implementation and enforcement by Member States). However, it is worth noting that the European Securities and Markets Authority (ESMA) took over CESR's responsibilities starting in 2011. Baptiste Aboulian, *Funds Seeking Clues on Rule Approach by ESMA*, FIN. TIMES (London), Feb. 28, 2011, at 9. Nonetheless, this note will continue to refer to CESR for the sake of consistency.

106. Council Directive 2007/16, *supra* note 67, art. 2(2); Kovas, *supra* note 19, at 13–14.

107. ALAIN LECLAIR ET AL., POURING OLD WINE INTO NEW SKINS?: UCITS AND ASSET MANAGEMENT IN THE EU AFTER MIFID 39 (2008) (citing Council Directive 2007/16, *supra* note 67).

108. *See* Dejmek, *supra* note 15, at 473–74.

109. *See* Lamandini, *supra* note 42, at 6.

110. *Id.* (quoting Friedrich Heinemann, *The Benefits of Creating an Integrated EU Market for Investment Funds* 2 (ZEW, Discussion Paper No. 02-27, 2002), *available at* http://econstor.eu/bitstream/10419/24779/1/dp0227.pdf).

111. *See id.* (quoting Heinemann, *supra* note 110, at 3–4).

112. The EC presented a White Paper, highlighting the need to boost efficiency and facilitate market-driven restructuring of the investment fund market through amendments to UCITS III. *See White Paper on Enhancing the Single Market Framework for Investment Funds*, COM (2006) 686 final (Nov. 15, 2006); Grace et al., *supra* note 13, at 574. The White Paper found up to €762 million in potential annual savings, largely through permitting the centralization of management. Grace et al., *supra* note 13, at 574. Unresolved questions pertaining to such issues as the "scope of the 'management'" company passport, extent of supervision and tax issues, in coordination with the Internal Market and Services Directorate General of the Commission (DG MARKT), also provided the groundwork for shaping UCITS IV. *Id.* at 574–75.

supervisory authority; (2) fund mergers; (3) asset pooling; (4) management company passports; and (5) a simplified prospectus.[113]

UCITS IV was proposed in July 2008[114] and approved by the European Parliament and the European Council almost a year later.[115] Member States are required to adopt UCITS IV at the national level by June 30, 2011,[116] in coordination with further advice from the Committee of European Securities Regulators (CESR),[117] which has begun providing Level 2 technical advice[118] on the key changes encompassed in UCITS IV.[119] Though the areas of concern were putatively addressed in the five new chapters comprising UCITS IV,[120] it may be too early to determine their true impact.

B. Changes From UCITS III to UCITS IV

1. Notification

An important change within UCITS IV is the further simplification of the notification procedure that allows a UCITS fund to be marketed in a Host Member State.[121] Under UCITS IV, a UCITS fund seeking to market its units in another Member State may see faster approval and greater regulatory harmonization across Member States.[122] Unlike UCITS III, a fund under UCITS IV may simply send notification of its desire to market its fund in a Host Member State to its Home Member State regulator, who will then send notification to the Host Member State within ten days.[123] Given the wide variety of information requested by Host Member States in granting authorization under UCITS III,[124] costly, time-consuming delays often extended the stated two-month maximum review period.[125] UCITS IV

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113. *See* Council Directive 2009/65, *supra* note 22, at L42–43.

114. Dejmek, *supra* note 15, at 473.

115. *See* Council Directive 2009/65, *supra* note 22, art. 116.

116. *Id.*

117. *See* Dejmek, *supra* note 15, at 473. CESR provides technical advice to the EC on securities-related measures. *Id.* at 463. For a detailed description of the Lamfalussy framework, under which CESR operates, see *id.* at 462–64.

118. *See supra* note 105 and accompanying text.

119. Letter from Eddy Wymeersch, Chair, Comm. of European Sec. Regulators (CESR), to Jörgen Holmquist, Chair, European Sec. Comm. (Oct. 28, 2009), http://www.esma.europa.eu/popup2.php?id=6152.

120. Dejmek, *supra* note 15, at 473.

121. *See* Lamandini, *supra* note 42, at 8.

122. *See id.* at 9.

123. Council Directive 2009/65, *supra* note 22, art. 93. A fund no longer has to send notification to the Host Member State itself. *See id.*

124. For example, a fund wishing to passport into Italy had to submit an "extended application form" and a fund wishing to passport into France had to submit a "French addendum" or "French marketing memorandum." Anderberg & Brescia, *supra* note 23.

125. Rouch & Smith, *supra* note 16, at 257. Notification costs trim about 0.25 basis points off total fund costs with estimated annual costs for continuing notification at €25 million in addition to upfront costs of €25 million, not including lost opportunity costs due to delays. *Impact*

should speed up that process, in that a UCITS fund may begin marketing *immediately* once the Home Member State forwards the paperwork to the Host Member State.[126] A Host Member State regulator is no longer able to review and reject authorization prior to the fund's actual marketing, but may only do so ex post.[127]

In addition to the notification procedure, the package of documents to be submitted to regulators has also been simplified.[128] Under UCITS IV, a fund need only submit: (1) a notification letter; (2) its charter; (3) its prospectus; (4) its latest annual and semi-annual report; and (5) its key investor information document (KII).[129] Although much of this information was previously required under UCITS III, Host Member States were permitted to—and did—request additional information,[130] which is prohibited under UCITS IV.[131] Additionally, Host Member States were able to impose translation requirements for various documents under UCITS III,[132] imposing additional costs on UCITS funds seeking authorization.[133] However, under UCITS IV, only the KII is required to be translated into a local language, whereas the other documents are now able to be translated "at the choice" of a UCITS fund into the language of the Host Member State or "a language customary in the sphere of international finance" like English.[134] These changes may help reduce barriers to entry and compliance costs,[135] while encouraging further harmonization.

Assessment of the Legislative Proposal Amending the UCITS Directive, at 66–67, SEC (2008) 2263 [hereinafter *UCITS Impact Assessment*].

126. *See* Council Directive 2009/65, *supra* note 22, art. 93. However, Natixis Asset Management anticipates that "regulators will have 'wheelbarrows' full of documents" from large fund managers upon implementation of UCITS IV in July 2011, which may reduce the efficiency of the notification procedure for managers. Baptiste Aboulian, '*Paperwork Surprise in Store for Regulators'*, FIN. TIMES (London), Nov. 8, 2010, at 15.

127. *See* RBC DEXIA INVESTOR SERVICES, TOWARDS THE NEXT GENERATION: MOVING FROM UCITS III TO UCITS IV 17 (May 2009), *available at* http://www.rbcdexia.com/documents/en/UCITS/From_UCITS_III_to_IV.pdf [hereinafter RBC DEXIA PRESENTATION].

128. *See id.*

129. *See* Council Directive 2009/65, *supra* note 22, art. 93.

130. *See* Anderberg & Brescia, *supra* note 23.

131. Council Directive 2009/65, *supra* note 22, art. 93(6).

132. *See* Council Directive 2001/107, *supra* note 16, art. 47.

133. *See* Karen L. Anderberg, *UCITS and the Cross-Border Registration Process*, PLC CROSS-BORDER HANDBOOK (Mar. 2009), www.practicallaw.com/2-384-8117.

134. Council Directive 2009/65, *supra* note 22, art. 94(1)(c).

135. Such ongoing compliance costs include: (1) "filing of periodic sales reports in various jurisdictions"; (2) complying with "[d]iffering requirements for annual [and extraordinary] general meetings"; (3) seeking pre-approval of advertising material; (4) complying with varying tax requirements; and (5) complying with "[v]arious translation and mailing requirements." Anderberg & Brescia, *supra* note 23.

2. Key Investor Information Document

Under UCITS III, the contents of the "simplified prospectus" were subject to uneven interpretation and application by Member States,[136] sometimes lengthening the level of detail required.[137] These supplemental requirements imposed an estimated €1 million in annual expenses for translation and printing of investor disclosures for a UCITS fund.[138] Though the situation improved in 2004 when the EC issued a "Recommendation"[139] outlining the specific contents of the simplified prospectus, the recommendation remained largely advisory.[140] As a component of the revised notification process, the KII acts to simplify the disclosure of pertinent information used by investors.[141] The KII is designed to allow average retail investors to understand the nature and risks of their investment in a given UCITS fund in their own language and in a non-technical manner,[142] and to allow investors to better compare their options in a simple, concise format.[143] With the implementation of KII, investors may be able to more easily compare funds and managers may find it easier to offer a standardized set of disclosures, regardless of the Host Member States to which they apply.

3. Fund Mergers

Under UCITS III, market inefficiencies in the EU have kept UCITS funds to about one-fifth the size of similar funds in the U.S.[144] Due to the presence of domestic-only merger regimes and the absence of a cross-border regime, smaller funds have been unable to combine with affiliated funds in other Member States in order to more efficiently operate and to take advantage of economies of scale that would reduce the costs passed on to investors.[145] Under UCITS IV, Member States must allow cross-border mergers, in addition to domestic mergers.[146] However, the ability to conduct

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136. Rouch & Smith, *supra* note 16, at 258.

137. Variation in national requirements allowed some regulators to take a "lax approach" and others to take a more "risk-averse stance" to UCITS funds seeking authorization, allowing some regulators to ask for far more detail, thereby defeating the purpose of a "simplified" prospectus. *See* LECLAIR ET AL., *supra* note 107, at 41.

138. *UCITS Impact Assessment*, *supra* note 125, at 119.

139. Commission Recommendation 2004/384, 2004 O.J. (L 144) (EC).

140. Rouch & Smith, *supra* note 16, at 258.

141. RBC DEXIA PRESENTATION, *supra* note 127, at 7.

142. Council Directive 2009/65, *supra* note 22, art. 78(5). The KII is only allowed to contain the following: (1) "identification of the UCITS"; (2) "a short description of its investment objectives and investment policy"; (3) past performance presentation or scenario; (4) "costs and associated charges"; and (5) the "risk/reward profile of the investment" with applicable warnings. *Id.* art. 78(3), (6).

143. *Id.* art. 78(5).

144. Schmidt, *supra* note 11, at 177. "At the end of 2006, 54% of EU funds managed less than €50 million in assets . . . ." *UCITS Impact Assessment*, *supra* note 125, at 81.

145. *See* Rouch & Smith, *supra* note 16, at 259.

146. Council Directive 2009/65, *supra* note 22, art. 38.

cross-border mergers is not without restriction.[147] Mergers must be authorized by the merging member's Home Member State to be effectuated and a decision must be made by the regulator within twenty days after the supporting documentation is submitted.[148] UCITS IV also provides for an extensive and exhaustive list of "common draft terms of merger" that must be included as a part of the aforementioned documentation.[149] In fact, a "vast majority" of UCITS fund managers plan to consolidate geographically-disperse funds upon implementation of UCITS IV, with 43% of surveyed managers indicating cost savings as the primary reason for seeking to merge and 24% indicating easier access to markets as their rationale.[150] It has been estimated that allowing mergers could save the European asset management industry €5 billion a year.[151]

4. Master-Feeder Structures

UCITS IV has also introduced the ability to pool assets in the form of master-feeder structures.[152] Under UCITS III, the 10% limit on investment in assets of another UCITS fund prevented the formation of feeder funds.[153] However, under UCITS IV a master-feeder structure can now be established to allow a feeder fund to invest over 85% of its assets in a master fund, while retaining up to 15% of its assets in liquid assets, derivatives for hedging purposes, and property essential for operation of the fund.[154] A feeder fund must obtain authorization to operate as such by submitting documentation to its Home Member State regarding its relationship with a master fund, the identity of its depositary, a prospectus and KII, and its investment policy.[155] Importantly, despite requiring an attestation from the feeder fund regarding the legal identity of the master fund, these two funds may be established in separate Member States on a

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147. *See id.* art. 39–40.

148. *Id.* art. 39.

149. *Id.* art. 40. Some of the common draft terms include: type of UCITS involved, "rationale" for merger, and "expected impact" of merger. *Id.*

150. Giovanni Legorano, *Managers Set to Consolidate in Preparation for UCITS IV*, GLOBAL PENSIONS (Oct. 26, 2009), http://www.globalpensions.com/global-pensions/news/1559782/managers-set-consolidate-preparation-ucits-iv.

151. *UCITS Impact Assessment*, *supra* note 125, at 81.

152. Council Directive 2009/65, *supra* note 22, art. 58. A master-feeder structure pools investments from various feeder funds into a master fund in order to produce economies of scale and particular tax advantages. Effie Vasilopoulos & Katherine Abrat, *The Global Dream: The Use of Master-Feeder Fund Structures by Asian-Based Hedge Fund Managers*, EUREKAHEDGE (Nov. 2005), http://www.eurekahedge.com/news/05_nov_sidley_austin_master_feeder_structures.asp. Local investors invest in a domestic feeder fund that subsequently invests substantially all its assets in a master fund located elsewhere, which provides beneficial tax effects generally unavailable otherwise to the local investor. *Id.*

153. Helm & Babikian, *supra* note 77, at 861.

154. Council Directive 2009/65, *supra* note 22, art. 58.

155. *Id.* art. 59. The feeder fund is entitled to receive a decision regarding approval within fifteen days. *Id.* art. 59(2).

cross-border basis.[156] Efficiency gains could be realized when the master-feeder structure[157] is used in conjunction with the merger provisions.

5. Management Company Passport (MCP)

Although the revised Management Company Passport was almost not included in UCITS IV[158] due to concerns that allowing the passporting of management and administrative services could "rob the authority responsible for the fund of the means to monitor and to ensure compliance,"[159] it was nevertheless included as an important, albeit controversial, part of UCITS IV.[160] This "real"[161] MCP was designed to enable greater efficiency and specialization, allowing fund managers to benefit from economies of scale and cost savings.[162] The prior management passport under UCITS III created inefficiencies as UCITS funds established in contractual or unit trust form were not able to actually appoint a management company to oversee a fund in another Member State.[163] As a result, only 10% of management companies actually passported their services.[164] However, this failure has been addressed in UCITS IV.

Under UCITS IV, the management company is only subject to prudential supervision by its Home Member State,[165] despite having branches or providing services within other Member States.[166] A management company must submit documentation to its Home Member State regulator in order to establish a branch in a Host Member State and the Home Member State regulator will forward the paperwork to the Host Member State regulator within two months, unless it has reason to doubt the

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156. *See id.* art. 59.

157. The master-feeder fund structure could save Europe's fund industry between €2 billion and €3 billion a year. Steve Johnson, *UCITS IV Offers Huge Savings*, FIN. TIMES (London), Aug. 2, 2010, at 2.

158. *See* Lamandini, *supra* note 42, at 10.

159. Grace et al., *supra* note 13, at 576.

160. *See* David Adams, *UCITS IV-The Next Stage*, INT'L CUSTODY & FUND ADMIN. (Sept. 24, 2009), http://icfamagazine.com/public/showPage.html?page=icfa_display_feature&tempPageId=869229.

161. LECLAIR ET AL., *supra* note 107, at 3.

162. *See* Grace et al., *supra* note 13, at 576.

163. *See* Rouch & Smith, *supra* note 16, at 256. However, UCITS funds organized in corporate form were able to appoint a management company. *See id.*

164. *UCITS Impact Assessment*, *supra* note 125, at 110.

165. Home Member States are responsible for ensuring that each management company has sound "administrative and accounting procedures," internal safeguards and controls for transactions, and procedures that minimize potential conflicts of interest between the company and its clients. Council Directive 2009/65, *supra* note 22, art. 12(1). Management companies must also have a minimum of €125,000 in capital, be managed by persons of "sufficiently good repute and . . . experience" and have their head office and registered office in the same Member State to become authorized. *Id.* art. 7(1).

166. *See id.* art. 10(2).

adequacy of the company's administrative structure or financial situation.[167] Allowing management companies to consolidate could decrease a fund's expenses, as establishing and maintaining separate management companies in Host Member States may cost a given fund up to €1 million a year.[168]

III. THE TRUE COST OF COMPLIANCE: UCITS IV AND HEDGE FUNDS

It would be a mistake to call the improvements from UCITS III to UCITS IV immaterial or nugatory. However, UCITS IV may still impose significant costs on hedge funds seeking a UCITS wrapper.[169] While it is too early to tell how effective UCITS IV will be in actually achieving the original goals of the UCITS Directives,[170] certain costs and benefits may already be apparent. However, the full extent of these costs and benefits may not be readily apparent to funds seeking compliance under the UCITS Directives, especially given the specter of hedge fund registration in the U.S. and the AIFM Directive in the EU seemingly pushing funds to seek UCITS compliance.[171] As such, the rush of hedge funds seeking compliance under UCITS IV may be premature, absent certain necessary amendments.

A. WEIGHING THE COSTS AND BENEFITS OF FORMING A UCITS IV-COMPLIANT FUND

The UCITS structure offers several benefits to hedge fund managers under UCITS IV. Importantly, investors have turned their attention to issues of liquidity, transparency, and operational control amid recent market turmoil[172] and UCITS IV presents a vehicle where these concerns can be met through a strongly regulated investment vehicle.[173] Though a UCITS fund is more heavily regulated than the typical hedge fund, a unique benefit of the UCITS structure is its ability to utilize sophisticated financial instruments and strategies.[174] Additionally, UCITS IV allows hedge fund managers to gain access to a larger investor base through the use of the

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167. *See id.* art. 17. The Host Member State has an additional two months to consider the request, allowing the management company to establish a branch after that two month period if no objection is made. *Id.* art. 17(6), (7).

168. *UCITS Impact Assessment*, *supra* note 125, at 110.

169. Goh, *supra* note 29.

170. *See* discussion *supra* Introduction.

171. *See* Thiha Tun & Samantha Shankar, *Hedge Fund Focus: What Are the Key Issues?*, COMPLINET (July 29, 2009), http://www.herbertsmith.com/NR/rdonlyres/89928414-F367-4E8A-AB03-000896A55D96/11894/Hedgefundfocus.pdf.

172. Christopher D. Christian & Stephanie A. Barkus, *UCITS: An Opportunity for Hedge Fund Managers*, THE HEDGE FUND LAW REP., July 8, 2009, http://www.hflawreport.com/print/article/433.

173. *Id.*

174. *See* Hawks, *supra* note 5, at 190.

passport, reaching both retail and institutional investors,[175] and doing so in a more efficient manner given recent changes.[176] Taking advantage of a UCITS structure also presents an opportunity to take part in an industry that is poised to expand to €8 trillion by 2012.[177] Additionally, the UCITS "badge" acts as an indication of "regulatory scrutiny and credibility that engenders investor confidence."[178]

However, the UCITS Directives impose significant limitations on hedge funds as currently formulated; it is not for the "faint-hearted"[179] nor a "silver bullet."[180] Upfront costs for hedge funds seeking UCITS compliance include authorization paperwork, establishing infrastructure in Europe, and complying with capital requirements that do not exist in the U.S.[181] For example, compliance with advertising and marketing rules, even after UCITS IV, may continue to impose high fixed costs upon funds passporting into other Member States.[182] However, independent providers and investment banks may help alleviate certain startup costs for managers by offering platforms that reduce the cost and time associated with launching a fund.[183] Nevertheless, ongoing costs include forming efficient compliance and risk management departments, whose costs will only be able to be

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175. *See* Christian & Barkus, *supra* note 172. *But see* Cecilia Valente, *Europe Fund Firms to Shun Low-Cost Centres-Study*, REUTERS, Oct. 25, 2009, *available at* http://www.reuters.com/article/rbssInvestmentServices/idUSB42497820091026 (explaining how the mere availability of alternate markets does not mean that each country will be a desirable location to market a UCITS fund).

176. Though a survey by Ernst & Young reveals that fund managers are looking to UCITS IV more for business model alignment than as a way to bring operational cost reductions. Press Release, Ernst & Young, Investment Funds Move UCITS IV Focus to Business Model Alignment and Operational Efficiency (Jan. 12, 2010), http://www.ey.com/RU/en/Newsroom/News-releases/Press-Release---2010-01-12. According to BlackRock's country head for Italy, Andrea Viganò, investors may not realize the full benefits of UCITS IV for a number of years. Andrew Fanko, *UCITS IV Benefits Years Away: BlackRock*, IGNITES EUROPE (Aug. 13, 2010), http://www.igniteseurope.com/c/116325/11148/ucits_benefits_years_away_blackrock.

177. Christian & Barkus, *supra* note 172.

178. Paul Allen, *Hedge Funds Covet UCITS Badge*, WEALTH-BULLETIN (June 15, 2009), http://www.wealth-bulletin.com/home/content/1054445328. Simon Firth, a partner at Kaye Scholer LLP, has stated that "a UCITS wrapper dispels in one fell swoop questions about transparency and lack of regulation that have plagued the offshore model." *Id.*

179. Fischer, *supra* note 41.

180. *BlackRock's Clarvit Blasts UCITS Structure*, FINALTERNATIVES (Mar. 4, 2010), http://www.finalternatives.com/node/11649.

181. Fischer, *supra* note 41.

182. *See* Lamandini, *supra* note 42, at 15.

183. Heather Dale, *Hedge Funds Lean on Platforms for UCITS Entry*, IGNITES EUROPE (Feb. 22, 2010), http://www.igniteseurope.com/articles/20100222/hedge_funds_lean_platforms_ucits_entry. Though arranging for platforms risks certain tradeoffs like "exclusivity arrangements," loss of control, and associated risk through others operating on the same platform. STRATEGIC INSIGHT, ALTERNATIVE AND HEDGE FUND UCITS IN THE NEXT DECADE 15 (Nov. 25, 2010), http://www.alfi.lu/publications-statements/publications/alternative-and-hedge-fund-ucits-next-decade [hereinafter ALTERNATIVE AND HEDGE FUND UCITS IN THE NEXT DECADE].

absorbed by larger funds.[184] Additionally, on the products side, fund managers are not permitted to utilize certain familiar strategies or investments within the UCITS Directives and may subsequently be unable to effectively operate the fund by shoehorning into a UCITS wrapper.[185] Additionally, the fourteen-day maximum redemption period—made available at the fund's net asset value—limits a fund from taking positions in more illiquid assets, which may often be necessary to effectuate a particular strategy.[186] As such, some strategies are more likely to be repackaged as UCITS than others.[187] Overall, these regulatory constraints are passed on to investors in the form of higher fees[188] and may result in a drop in performance.[189] However, it is still too early to tell whether UCITS funds employing hedge fund strategies currently outperform traditional hedge funds, especially considering the variety of strategies in existence.[190] Regardless, these regulatory constraints have the potential to exert severe pressure on smaller hedge funds seeking to stay afloat through a UCITS

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184. *See* Fischer, *supra* note 41. For example, under UCITS IV, funds must demonstrate they have sufficient risk controls to monitor exposures and must limit risk based on Value at Risk (VaR) and tracking error. Goh, *supra* note 29. VaR is generally a measurement of the probability of losses based on an analysis of historical price "trends and volatilities." *Value at Risk—VaR*, INVESTOPEDIA, http://www.investopedia.com/terms/v/var.asp (last visited Nov. 22, 2009). Tracking error is the difference between the "price behavior of a position or a portfolio" relative to a certain benchmark. *Tracking Error*, INVESTOPEDIA, http://www.investopedia.com/terms/t/trackingerror.asp (last visited Nov. 22, 2009).

185. *See* Philip Haddon, *Newcits: What Will Hedge Funds Bring to the Ucits III Space?*, CITYWIRE (Dec. 1, 2009), http://www.citywire.co.uk/selector/-/news/new-products/content.aspx?ID=370488&Page=3 (discussing how some managers may find the transparency and liquidity restrictions to be incompatible with their particular strategy, while others may find that the limits on leverage and shorting will prevent them from effectively operating a UCITS fund).

186. *See* Christian & Barkus, *supra* note 172.

187. Equity long/short strategies are seen as the most likely to be repackaged as UCITS and event-driven strategies are seen as the least likely. NOËL AMENC & SAMUEL SENDER, EDHEC-RISK INSTITUTE, ARE HEDGE-FUND UCITS THE CURE-ALL? 9 (2010), *available at* http://www.edhec-risk.com/features/RISKArticle.2010-03-24.5003/attachments/EDHEC%20Risk%20Publication%20Hedge%20Fund%20UCITS.pdf.

188. Such costs passed on in the form of fees are estimated to be approximately 40–75 basis points for administrative and platform costs and 60–90 basis points for distribution out of a standard 2% management charge. Pauline Skypala, *Hedge Funds Cashing in on UCITS*, FIN. TIMES (London), Sept. 28, 2009, at 6.

189. According to a survey by KdK Asset Management, more than 90% of fund-of-funds believe UCITS employing hedge fund strategies will have lower returns than their offshore counterparts, with 25% of them expecting the performance gap to be as big as three percentage points a year. Steve Johnson, *UCITS Hedge Vehicles to Flood Sector*, FIN. TIMES (London), Jan. 11, 2010, at 1. Nick Sketch, senior investment director at Rensburg Sheppards Investment Management, likened the fallacy that a hedge fund strategy can successfully be modified to fit into a UCITS fund to "'having a horse with four legs that runs at 40 miles per hour, and saying that when you back-test that horse with three legs it can run at 30 miles per hour.'" *Access and Assurance: Bridging Asset Classes: Derivatives Structuring*, THE BANKER, July 1, 2010, *available at* 2010 WLNR 13453004 (citation omitted).

190. *See* Nils S. Tuchschmid et al., *Will Alternative Ucits Ever Be Loved Enough to Replace Hedge Funds?* 30 (Working Paper 2010), *available at* http://ssrn.com/abstract=1686055 (explaining that there is no conclusive evidence that more traditional hedge funds as a group outperform UCITS employing hedge fund strategies as a group).

platform.[191] Thus, while UCITS IV presents a salient opportunity for hedge funds, up-front and ongoing costs may be too high to justify such a conversion at the moment without certain amendments that would alleviate these costs.

B. External Forces Causing a False Start

1. Private Fund Investment Advisers Registration Act in the U.S.

While the cost-benefit analysis will be different for each fund in determining whether to establish a UCITS IV-compliant fund, certain external forces have the potential to skew certain managers' perceptions of the appropriateness of establishing that fund. One such external force is Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act, also known as the Private Fund Investment Advisers Registration Act of 2010 (the Registration Act).[192] While nearly 55% of U.S. based hedge funds had registered with the Securities and Exchange Commission (SEC) by the beginning of 2009,[193] the Registration Act requires an investment adviser of hedge funds to register with the SEC under the Investment Advisers Act of 1940 (Advisers Act) if it has more than $150 million in assets under management.[194] In addition to complying with the Advisers Act, the Registration Act requires registered advisers to disclose a variety of information to the SEC,[195] maintain books and records,[196] and be subject to systemic risk supervision[197] and possible examinations.[198] Granted, impending registration adds a layer of regulation previously unknown to unregistered investment advisers of hedge funds, but the disclosure-centric

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191. Chris Newlands, *Fundwatch: Hedge Funds Take a Hit in UCITS Drive*, ALLBUSINESS (Sept. 28, 2009), http://www.allbusiness.com/banking-finance/financial-markets-investing-funds/13082868-1.html.

192. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, §401, 124 Stat. 1376 (2010).

193. Press Release, Hedge Fund Research, Inc., Hedge Fund Research Releases Data on Number of Hedge Fund Firms Registered with the Securities and Exchange Commission (Feb. 2, 2009), https://www.hedgefundresearch.com/pdf/pr_20090202.pdf.

194. Dodd-Frank Wall Street Reform and Consumer Protection Act §408 (adding subsection (m) to Section 203 of the Advisers Act, which provides an exemption from registration for advisers of private funds who manage less than $150 million in assets under management in the U.S.).

195. *See id.* §404(3) (amending Section 204 of the Advisers Act). The Act requires the following information to be disclosed: (1) assets under management; (2) leverage usage; (3) counterparty credit risk exposure; (4) type of assets held; (5) valuation and trading practices; (6) any side arrangements; (7) trading and investment positions; and (8) "such other information as the [SEC] . . . determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk." *Id.*

196. *Id.* §404(4).

197. *Id.* §404(7).

198. *Id.* §404(6).

requirements within the Registration Act will not necessarily alter a particular fund's overall operation and strategy—it will only require that certain information is reported.[199]

Accordingly, investment advisers seeking to avoid registration in the U.S. may not find protection under a UCITS wrapper. As previously mentioned, UCITS funds are highly liquid, invest in a defined set of assets, avoid significant amounts of leverage, and do not engage in short selling.[200] Alternatively, a hedge fund that does not have formal diversification rules or limits on its range of investments is able to restrict redemption periods and may engage in strategies employing significant amounts of leverage and short selling.[201] The Registration Act promises to monitor these activities more closely, but it does not restrict these activities as in the UCITS Directives.[202] Thus, despite the threat of registration in the U.S., a UCITS-compliant fund may not make sense as an alternative for managers seeking a less burdensome regulatory regime under UCITS IV.

2. Alternative Investment Fund Managers Directive in the EU

More critical to the decision of hedge funds seeking a UCITS wrapper is the potential scope and effect of the AIFM Directive,[203] which was passed in late 2010.[204] While many hedge fund managers may have rightly been anxious about the potential effects of the initial AIFM Directive,[205] the final version has potentially allayed fears[206] and rendered the decision to launch a UCITS-compliant fund less compelling as a means of regulatory avoidance. The AIFM Directive, as first proposed on April 29, 2009,[207] sought to

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199. *See* Memorandum from Patton Boggs LLP on the Status of Proposed Legislation for Increased Regulation of Investment Advisers and the Private Funds They Manage (Sept. 2009), http://www.pattonboggs.com/news/detail.aspx?news=941 (follow "Click here for the full PDF" hyperlink). For the same reason that many fund managers chose to remain registered after the SEC attempted to require managers to register in 2004, instituting mandated compliance programs and other requirements pursuant to the Advisers Act and under the Registration Act help "enhance credibility and confidence" and attract investors. Janaya Moscony & José Santiago, *SEC Registration for Private Fund Investment Advisers—It's Not as Scary as You Think*, HEDGEWORLD DAILY NEWS, Oct. 2, 2009, *available at* 2009 WLNR 19481053.

200. *See* Syyrila, *supra* note 14, at 97.

201. *See id.*

202. *See* Council Directive 85/611, *supra* note 2; Council Directive 2001/108, *supra* note 17; Council Directive 2007/16, *supra* note 67.

203. *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC*, COD (2009) 64 (Oct. 27, 2010) [hereinafter *Final AIFM Directive Proposal*].

204. Mirzha de Manuel, *Why Passport Flexibility Comes at a Price*, FIN. TIMES (London), Dec. 13, 2010, at 6.

205. A March 2010 survey by the EDHEC Risk Institute reveals that over 60% of fund managers believe that the AIFM Directive leads to uncertainty about the distribution of funds and 92% of fund managers "'see a trend towards packaging [hedge fund] strategies as UCITS.'" AMENC & SENDER, *supra* note 187, at 8–9.

206. *See* ALTERNATIVE AND HEDGE FUND UCITS IN THE NEXT DECADE, *supra* note 183, at 7.

207. Europa Press Release, *supra* note 37.

regulate any alternative investment fund that was not a UCITS fund[208] with more than €100 million in assets under management.[209] Significantly, under the initial draft, funds based outside the EU could not market their funds in Europe for at least three years after implementation of the AIFM Directive, unless they were able to obtain authorization from a particular Member State and were based in a country with equivalent standards of prudential and ongoing regulation.[210] This could have closed off U.S. based hedge funds from European investors due to non-equivalent standards. Additionally, the initial draft of the AIFM Directive imposed wide-ranging restrictions on the operation of funds.[211] With these restrictions, it is easy to see why many hedge fund managers have sought cover under a UCITS wrapper.

However, the initial draft of the AIFM Directive met fierce opposition from the alternative investment industry and was heavily criticized in a report commissioned by the European Parliament, calling the directive "vague, sweeping and inadequate," "poorly-constructed, ill-focused and premature," and "protectionist."[212] This criticism was so cutting as to force certain compromises in subsequent redrafts.[213] However, while the sharpest edges of the initial draft have been sanded down,[214] and additional

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208. Thomas & Brooks, *supra* note 35.

209. *See Initial AIFM Directive Proposal*, *supra* note 35, at 5–6; Richard Horowitz, *Future Regulation of Private Funds: How the Draft EU Directive & US Legislative Proposals Compare*, THE HEDGE FUND LAW REP., May 7, 2009, http://www.hflawreport.com/print/article/350.

210. *See Initial AIFM Directive Proposal*, *supra* note 35, at 7; James Farrugia, *The AIFM Directive and Third Country Managers*, HEDGEWEEK (Sept. 1, 2009), http://www.hedgeweek.com/2009/09/01/aifm-directive-and-third-country-managers.

211. Some of the operational restrictions include: minimum capital requirements, an additional capital charge on assets under management above a certain threshold, an independent depositary, preapproval for any delegation, comprehensive disclosures to investors and regulators, caps on leverage, and restrictions on short selling. *See* Horowitz, *supra* note 209; *see also Initial AIFM Directive Proposal*, *supra* note 35.

212. Quick Impact Assessment on a Directive concerning Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/ . . . /EC at 6–7, EUR. PARL. DOC. PE 429.974 (2009), *available at* http://www.europolitique.info/pdf/gratuit_fr/260342-fr.pdf.

213. Both the European Parliament's Economic and Monetary Affairs Committee and the Economic and Financial Affairs Council passed conflicting compromise texts in May 2010. James Phillipps, *EU Approves AIFM Directive*, CITYWIRE (May 18, 2010), http://www.citywire.co.uk/new-model-adviser/eu-approves-aifm-directive/a400553.

214. *See* Memorandum from Mark V. Karmer, et al., Partner at Curtis, Mallet-Prevost, Colt & Mosle LLP, on AIFM Directive (Dec. 2010), http://www.curtis.com/sitecontent.cfm?pageID=21&itemID=506 [hereinafter Memorandum from Karmer et al.] (explaining how certain compromises were made "in the relatively watered-down depositary liability regime and the planned introduction . . . of a 'passport' for the marketing of non-EU funds within the [EU]"). The vague, initial reciprocity requirements were also amended in favor of bilateral agreements on the exchange of information, not being a non-cooperating country in terms of terrorist financing and money laundering, and compliance with certain model tax convention standards. *Final AIFM Directive Proposal*, *supra* note 203, art. 35. The national private placement regime will also remain in force until it is phased out in 2018, despite non-EU firms only being able to apply for the passport in 2015. *See id.* art. 63(1), 63bis, 63ter.

provisions have been added,[215] certain aspects of the initial proposal still remain.[216] Even though many hedge funds were rightly concerned about the deleterious effects of the AIFM Directive as initially drafted and factored this into their decision to pursue a UCITS wrapper, recent amendments have rendered those decisions to be somewhat short-sighted[217] relative to the true costs of compliance under UCITS IV as it stands.[218]

IV. OVERCOMING OBSTACLES: REALIZING THE GOALS OF UCITS

While the current influx of hedge funds converting to UCITS funds may be somewhat premature considering the relative costs and the concerns over regulation, certain amendments to UCITS IV could rationalize this decision for many managers. Such amendments include further simplification and clarification of the notification procedures, greater product flexibility, depositary passporting, tax harmonization, and less restrictive distribution channels.[219] With these amendments, many hedge fund managers and UCITS fund managers will better be able to justify the decision to become UCITS-compliant on a cross-border basis, due to a more fully integrated investment fund market. While all Member States are required to implement UCITS IV on a national basis by June 30, 2011,[220] certain changes to UCITS IV should still be made; the industry "can't afford to wait for UCITS V"[221] which will likely be a priority for the EC starting in 2011 and will focus on investor protection, rather than efficiency of the European fund market, and could take up to five years.[222]

A. STREAMLINE NOTIFICATION AND IMPROVE THE PASSPORT

Although UCITS IV has improved investor disclosure requirements and streamlined the notification process to potentially allow for greater

215. *See* Memorandum from Karmer et al., *supra* note 214 (explaining that the additional requirements concerned "managers' future reporting and disclosure towards regulators and investors, their minimum capitalization, remuneration, risk management, liquidity, use of leverage on the fund level, conflicts of interest, fund control positions in portfolio companies, fund portfolio valuation, and marketing/fundraising").

216. *See id.* (explaining that "the adopted text maintains the core features of the original proposal aimed at achieving better investor protection, enhanced transparency, and effective prudential oversight of systemic risks").

217. *See id.*

218. *See* Fischer, *supra* note 41.

219. These amendments address both "policy induced" (tax, passporting and products) and "natural" obstacles (distribution channels). *See* Heinemann, *supra* note 110, at 10 (explaining how "policy induced" obstacles may be eliminated through legislation, yet "natural" obstacles are a result of "consumer preferences" or "the inherent characteristics of [the] market").

220. Council Directive 2009/65, *supra* note 22, art. 116(1).

221. *UCITS IV: The Next Generation*, FUNDAMENTALS (Sept. 29, 2008), http://fundamentalsmagazine.com/news/353/ucits-iv-next-generation.

222. Baptiste Aboulian, *Commission Makes UCITS V a Priority*, IGNITES EUROPE (Apr. 8, 2010), http://www.igniteseurope.com/articles/20100408/commission_makes_ucits_priority.

integration of the investment fund market in Europe, these improvements may fall short when translated from paper to practice. While the KII has the opportunity to simplify the cross-border marketing of a UCITS fund to investors in various Member States, the efficacy of this document heavily relies on all Member States agreeing on common definitions and risk classifications to make the comparison of funds relevant and meaningful.[223] If the definitions and risk classifications are overly broad, the KII will likely be no better than UCITS III's "simplified prospectus" as individual Member States will have leeway to interpret the provisions and apply them as they see fit. Thus, the definitions and classifications should be drafted narrowly so as to avoid a multiplicity of interpretations.[224]

UCITS IV has arguably simplified the notification process by providing for immediate marketing within a Host Member State and only ex post review. However, providing notification of a fund's desire to operate in a Host Member State should be as simple as sending that notification *directly* to that state if the fund has already been authorized to operate in its Home Member State.[225] Additionally, the ability of a UCITS fund to immediately operate in a Host Member State directly collides with the ability of that state to impose local marketing rules on foreign UCITS funds, as mandatory compliance with local marketing laws may make immediate operation less of a reality.[226] As partial evidence of this skepticism, in a survey of asset managers, 10% cite the main drawback of UCITS IV as the concern that the MCP, the KII, and the notification process will not be as effective as advertised.[227] Furthermore, many fund managers who have not acquired or inherited a "'web of duplicate management companies and similar fund ranges'" will not likely even take advantage of an MCP[228] in place of focusing on maintaining a local point of contact and local expertise for clients.[229] As a result, an additional 10% of respondents cite the main drawback of UCITS IV as an increase in compliance costs and red tape, especially for managers who wish to remain domestic-based, yet need to

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223. *See* RBC DEXIA PRESENTATION, *supra* note 127, at 11.

224. A multitude of interpretations would significantly delay the implementation of time-sensitive decisions concerning investment strategy or investment focus, as a material change in a fund's business must be disclosed across *all* documents and relayed to every applicable Host Member State. *See* Anderberg & Brescia, *supra* note 23.

225. *See* RBC DEXIA PRESENTATION, *supra* note 127, at 15.

226. *See* Anderberg & Brescia, *supra* note 23.

227. KPMG & RBC DEXIA, UCITS IV: WHICH BUSINESS MODEL FOR TOMORROW? 37 (2009), http://www.rbcdexia.com/documents/EN/Misc/UCITS%20IV%20report.pdf [hereinafter KPMG & RBC DEXIA REPORT].

228. *See* Chris Newlands, *No "Appetite" for UCITS IV Company Passport*, IGNITES EUROPE (Nov. 27, 2009), http://www.igniteseurope.com/articles/print/20091127/appetite_ucits_company_passport (explaining how even organizations with duplicate management companies and similar fund ranges may see a greater and quicker impact from fund mergers, rather than the MCP).

229. *See id.* (explaining how a client may be alienated by the sheer distance from a manager operating in a different country, leading to a proximity problem and a risk of diminishing quality).

implement a risk management process.[230] Without resolving the conflict between local marketing rules and the ex post review procedure, addressing disclosure clarification issues, and accounting for purely locally based funds, UCITS IV may not reach its full potential.

B. UPDATING THE PRODUCTS DIRECTIVE

With the focus of UCITS IV primarily on the consolidation and simplification of UCITS funds throughout Europe, this Directive currently fails to address the need for further refinements concerning product regulation. As financial products and investment vehicles continue to evolve, a number of funds run the risk of falling outside the scope of the UCITS Directives.[231] The truth is that for a number of hedge funds, UCITS compliance will be a sizable step backward in sophistication.[232] For example, short sales continue to be prohibited,[233] despite being considered a legitimate investment strategy.[234] There may also be a case for allowing investments in commodities and "microfinance," which are presently excluded, despite their widespread use.[235] Additionally, the explosive growth in the variety of UCITS funds offered has incited calls for clearer labeling of UCITS products.[236] Currently, all UCITS funds are considered non-complex investments under the Markets in Financial Instruments Directive (MiFID), which allows managers to market a fund without assessing the knowledge or experience of an investor in this "execution-only" service.[237] However, the EC is holding a public consultation on whether to bifurcate UCITS funds into complex and non-complex investments, relegating managers overseeing complex investments to sophisticated investors with "knowledge and experience" only or

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230. KPMG & RBC DEXIA REPORT, *supra* note 227, at 38.

231. *See* Dejmek, *supra* note 15, at 473–74. *But see* Etienne Carmon, *The Missing Link to UCITS Success*, FT MANDATE (Feb. 1, 2007), http://www.ftmandate.com/news/fullstory.php/aid/1352/The_missing_link_to_UCITS_success.html (explaining that extending the scope of eligible assets has the potential to harm the reputation of UCITS).

232. *See* Haddon, *supra* note 185.

233. Rouch & Smith, *supra* note 16, at 254.

234. Anuj Gangahar & Deborah Brewster, *Hedging Industry Resents Taking Blame for Turmoil*, FIN. TIMES (London), Sept. 20, 2008, at 4. *But see* James Smith, *Hedge Funds Hope to Re-Build Confidence with UCITS Funds*, CITYWIRE (Nov. 25, 2009), http://www.citywire.co.uk/professional/-/news/income/content.aspx?ID=369520&Page=1 (explaining how certain UK hedge funds may find the restriction on short selling less of an issue as many use contracts for difference (CFDs) to replicate a shorting strategy).

235. *See* KPMG & RBC DEXIA REPORT, *supra* note 227, at 39.

236. *See* Baptiste Aboulian, *Euroview: Call for Clear Labeling on UCITS Products*, FT ADVISER (Oct. 19, 2009), http://www.ftadviser.com/InvestmentAdviser/Investments/Comment/article/20091019/050bb2de-b7da-11de-9bbb-00144f2af8e8/Euroview-Call-for-clear-labelling-on-UCITS-products.jsp.

237. *Commission Public Consultation on Review of the Markets in Financial Instruments Directive (MiFID)*, at 54 (Dec. 8, 2010), *available at* http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf.

eliminating the "execution only" regime entirely.[238] CESR did not support changing the UCITS categorization—though it abstained from taking any position in its MiFID advice to the EC—and neither did many within the industry.[239] While protecting retail investors from mistakenly investing in a UCITS fund utilizing hedge fund strategies makes sense in the abstract, the proposed KII may already provide an effective tool for disclosing the relative risk levels of a particular fund. Imposing an appropriateness test on a subcategory of UCITS funds may only lead investors to confuse complexity and risk.[240] In addition to more flexible investment strategies, a clearer description of certain risk factors will make it easier for managers to improve disclosures to investors and help investors be more aware of the risks inherent in each investment regardless of the Member State.

C. DEPOSITARY PASSPORTING

Depositaries work alongside UCITS funds and their management companies to ensure the safekeeping of assets.[241] The UCITS Directives have largely been silent on the role of depositaries; however, a depositary is required to have its registered office or branch in the same Member State as its fund and does not have a passporting feature associated with it,[242] thus fragmenting the funds associated with these depositaries. A passport for depositaries would go a long way in decreasing costs, facilitating fund mergers, and ensuring harmonization across borders.[243] However, a large majority of depositaries and custodians also find their roles to be "inappropriately defined."[244] At the beginning of 2009, the EC requested advice from CESR on potential improvements to depositaries in cross-border management situations and CESR delivered its advice later that year.[245] CESR proposed revising the definition of "safekeeping" by focusing on the "overall control of assets and segregation," including the possibility of delegating custody to sub-custodians, while clarifying the

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238. *Id.* at 54–56. The Chairman of the European Fund and Asset Management Association, Jean-Baptiste de Franssu, believes newcits are "a traffic accident waiting to happen" given that UCITS were never intended for sophisticated investors. Pauline Skypala, *De Franssu Warns on Newcits*, FIN. TIMES (London), July 19, 2010, at 2. There is additionally some concern that these newcits are pushing the boundaries of UCITS into dangerous territory. *See* David Ricketts, *PwC Identifies Newcits Hazards*, IGNITES EUROPE (Mar. 15, 2010), http://www.igniteseurope.com/articles/20100315/identifies_newcits_hazards.

239. Baptiste Aboulian, *Fight Likely Over Plan for 'Classes' of UCITS*, FIN. TIMES (London), Dec. 13, 2010, at 12.

240. *Id.*

241. Rouch & Smith, *supra* note 16, at 259.

242. *Id.*

243. *See id.*

244. AMENC & SENDER, *supra* note 187, at 10.

245. *See* Letter from Eddy Wymeersch, Chair, Comm. of European Sec. Regulators (CESR), to Charlie McCreevy, Comm'r, European Comm'n (Sept. 28, 2009), http://www.cesr-eu.org/popup2.php?id=6063.

depositary's liability and strengthening due diligence requirements with regard to the "selection, appointment, and periodic review of the sub-custodian."[246] Pursuant to CESR's advice, the EC has begun consultation on eventually incorporating depositary liability[247] and passporting[248] into UCITS V.[249] However, as important as the depositary function is, a survey of asset managers shows that only 3% consider the lack of a depositary passport the main drawback of UCITS IV.[250] Regardless, improvements in the depositary function will better allow managers to establish funds on a cross-border basis.

D. TAX HARMONIZATION

While allowing fund mergers to occur on a cross-border basis is an important step in creating a unified European investment fund market, tax issues must first be clarified and resolved before funds can realistically consider cross-border mergers.[251] Currently, "[s]ignificant discriminatory tax barriers" exist relating to the sale of foreign UCITS funds in each Member State's market.[252] Importantly, CESR has warned the EC of the potential tax obstacles to fund mergers within UCITS IV.[253] In fact, the tax situation is so vital to a fully harmonized investment fund market that UCITS IV may be a "dead directive" in Italy, unless its tax regime is revised.[254] On the other hand, more tax efficient destinations, such as Luxembourg and Ireland, have disproportionately high concentrations of UCITS funds domiciled there, leading to further balkanization.[255] One

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246. *Id.*

247. *Working Document of the Commission Services on Consultation Paper on the UCITS Depositary Function and on the UCITS Managers' Remuneration*, at 13–14 (Dec. 14, 2010), *available at* http://ec.europa.eu/internal_market/consultations/docs/2010/ucits/consultation_paper_en.pdf.

248. *Id.* at 16–17.

249. Adam Lewis, *EC Planning UCITS V to Apply 'Madoff Lessons'*, FUNDSTRATEGY (May 17, 2010), http://www.fundstrategy.co.uk/markets/eurozone/ec-planning-ucits-v-to-apply-madoff-lessons/1011766.article.

250. KPMG & RBC DEXIA REPORT, *supra* note 227, at 37.

251. *See* RBC DEXIA PRESENTATION, *supra* note 127, at 19. For example, "a cross-border merger [could] trigger[] tax charges . . . even though investors will not actually realise [sic] investments at the point a merger occurs. . . . [and] it is also possible that investors will be subject to higher tax rates." Adams, *supra* note 160.

252. *See* Heinemann, *supra* note 110, at 11 (summarizing several Member States' discriminatory tax measures).

253. Baptiste Aboulian, *CESR Call to Clarify Merger Tax Obstacles*, FIN. TIMES (London), Oct. 5, 2009, at 19.

254. David Ricketts, *"A Dead Directive": UCITS IV in Italy*, IGNITES EUROPE (Jan. 20, 2009), http://www.assogestioni.it/index.cfm/3,144,4837/ignites_europe_ucitsiv.pdf. Domestic funds in Italy are required to pay taxes on behalf of investors whether or not capital gains are realized, while elsewhere capital gains taxes are paid only when a fund is sold. *Id.*

255. For example, UCITS funds established in Luxembourg and Dublin are able to roll up income and gains with no tax, instead of having to distribute profits to avoid taxation. Carmon, *supra* note 231.

suggestion has been to treat cross-border fund mergers under UCITS IV as non-taxable events.[256] Significantly, a survey of asset managers suggests that the absence of a tax framework is the biggest drawback of UCITS IV, with 45% of respondents indicating concern over management company taxation, fund taxation, and investor taxation.[257] Additionally, allowance for cross-border mergers under UCITS IV may actually cause Home Member States to further complicate their domestic merger regulations in response, being unable to independently regulate on a cross-border basis, which will likely have an effect on the effectiveness of integration.[258] For example, certain Member States currently tax fund mergers at the investor level, which leads to situations where investors pay taxes on unrealized gains.[259] Additionally, under the laws of certain Member States, managing a fund on a cross-border basis could lead to a fund being a tax resident in the management company's Home Member State, instead of uniformly being taxable where the fund is established.[260] Further, certain Member States levy withholding taxes on cross-border dividend distributions to foreign feeders or impose a tax on redemptions in the country where their master fund is located, rather than having flows and transactions between master and feeder funds be tax neutral.[261] Without a harmonized tax regime across the EU, much of UCITS IV will not be able to be effectively implemented or utilized by the investment fund industry and full integration will not be realized.

E. EXPANSION OF DISTRIBUTION CHANNELS

An additional obstacle to a fully integrated investment fund market is existing distribution channels where banks and other distributors often steer customers toward "in-house" funds rather than third party funds.[262] The lack of investor choice that results from this type of favoritism and prevents foreign funds from reaching local investors must be addressed.[263] Solving

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256. Aboulian, *supra* note 253.

257. *See* KPMG & RBC DEXIA REPORT, *supra* note 227, at 37. *But see* Baptiste Aboulian, *Tricky Jumping UCITS IV Tax Hurdle*, FIN. TIMES (London), Dec. 7, 2009, at 20 (explaining how tax harmonization may be politically infeasible given the widely divergent tax structures of funds across Europe).

258. *See* RBC DEXIA PRESENTATION, *supra* note 127, at 15.

259. EFAMA & KPMG, ANALYSIS OF THE TAX IMPLICATIONS OF UCITS IV 4–5 (2010), http://www.kpmg.com/IM/en/IssuesAndInsights/ArticlesPublications/Documents/FINAL_EFAMA%20_Analysis_of_the_Tax_implications_of_UCITSIV.pdf.

260. *Id.* at 5.

261. *Id.* at 6.

262. *See* Lamandini, *supra* note 42, at 15–16. A substantial majority of fund managers believe that "there are problems with the distribution of hedge funds to retail investors." AMENC & SENDER, *supra* note 187, at 10.

263. Lamandini, *supra* note 42, at 16. *But see* Heinemann, *supra* note 110, at 12 (explaining that it is doubtful that mere consumer preferences greatly contribute to the fragmentation of the European market, as fund performance matters more than the fund's domicile to investors).

the conflict of interest problem could be a great boon to investors as 60% of the cost of fund management is tied to the "distribution process and network."[264] Cutting distribution costs would allow more funds to access foreign markets and retail investors and it would increase the integration of the investment fund market. However, it has been estimated by members of the industry that cross-border fund distribution is likely to continue to be "difficult and inefficient for at least another five years," despite the EC's recent attempts at correcting the problem.[265] Despite the large number of launches of UCITS funds employing hedge fund strategies, there is scant evidence that these vehicles are being fully funded due to skepticism by distributors as to the funds' abilities to comply with UCITS III and their general lack of experience with a retail client base.[266] Without addressing the collusive manner in which funds are distributed, full integration simply will not be possible.[267]

CONCLUSION

While the ink on UCITS IV is hardly dry, certain improvements need to be made in order to fully realize a truly integrated and efficient investment fund market in the EU. Addressing tax harmonization, fixing the current distribution scheme, adding depositary passporting, and improving both the notification and product restrictions would go a long way in making full and efficient integration a reality. However, this may be easier said than done. Part of the success of the UCITS Directives has been its "slow, carefully planned development."[268] Thus, while each of this note's proposals aim to improve upon UCITS IV, funds may continue to push forward and take the risk that UCITS IV will look as good in practice as it does on paper. Granted, funds already employing significant amounts of leverage, engaging in short selling, and investing in illiquid securities may

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264. Adams, *supra* note 160.

265. Sophia Grene, *UCITS IV 'No Magic Bullet' for Distribution*, FIN. TIMES (London), Oct. 5, 2009, at 2.

266. *See* Heather Dale, *Newcits Managers Naïve, Say Distributors*, IGNITES EUROPE (Feb. 23, 2010), http://www.igniteseurope.com/articles/20100223/newcits_managers_naive_distributors. Additionally, a Preqin survey reveals that as of March 2010, only 8% of European institutional investors have invested in UCITS employing hedge fund strategies, despite many considering an allocation. Christine Williamson, *UCITS on Investors' Minds, But Not in Many Portfolios*, PENSIONS&INVESTMENTS (Mar. 11, 2010), http://www.pionline.com/article/20100311/DAILYREG/100319969#ixzz18h40p86d. However, some investment banks have designed platforms to assist hedge fund managers in their distribution. Dale, *supra*. Still, just 50 funds captured 90% of net flows in 2010, demonstrating the concentration of investment in managers with a proven track record in the UCITS realm. ALTERNATIVE AND HEDGE FUND UCITS IN THE NEXT DECADE, *supra* note 183, at 5.

267. However, certain market trends may indirectly work to alleviate the bias. *See* Heinemann, *supra* note 110, at 12 (explaining that the "restructuring of distribution channels toward direct internet sales and independent fund shops," as well as the implementation of cross-border mergers and increasing investor sophistication will all work towards eliminating fund product bias).

268. Adams, *supra* note 160.

find compliance prohibitively burdensome, but the benefits are potentially tangible—namely passportability and access to retail investors. Though the AIFM Directive in the EU and the Registration Act in the U.S. promise more bark than bite for investment funds, heightened regulation appears to be here to stay—at least in the near term—forcing managers to consider all available options. Accordingly, while the cost of UCITS IV may prevent some funds from seeking a UCITS wrapper, certain amendments could make compliance possible for many more.

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