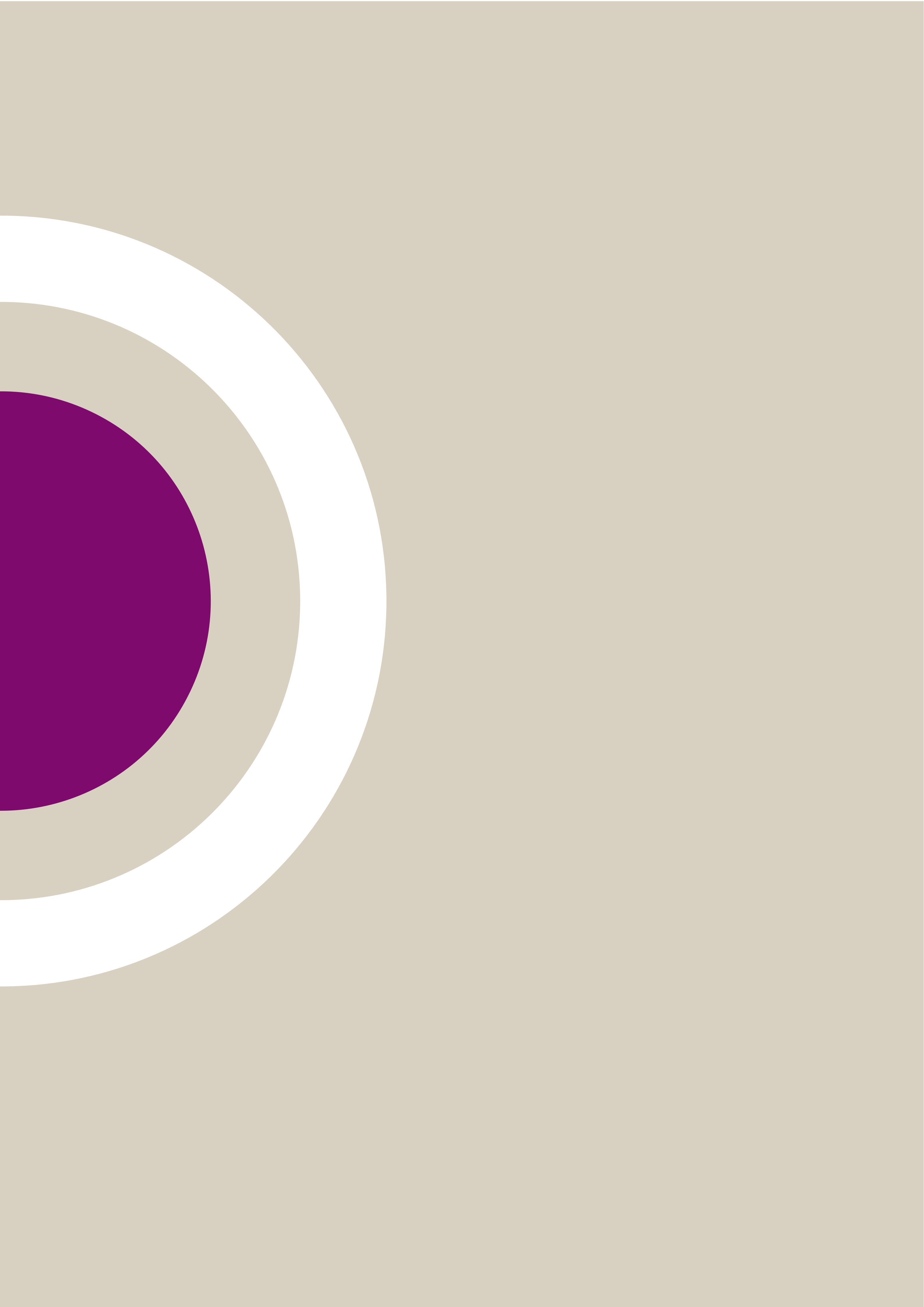
WHITE PAPER

UCITS IV

The transforming event for European asset managers and distributors

A research publication from BNP Paribas Securities Services

BNP PARIBAS
SECURITIES SERVICES



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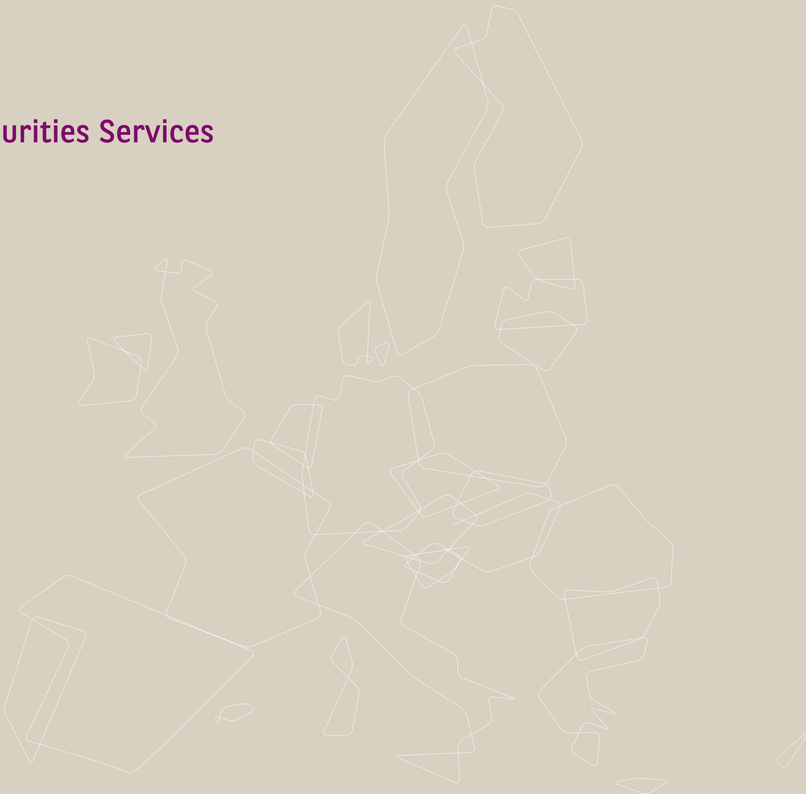


Foreword

I am delighted to introduce BNP Paribas Securities Services' white paper on the UCITS IV Directive. UCITS is an important piece of legislation that is essential to the integration of the financial markets in Europe and to the benefits of its citizens. European investors need to have access to efficient and reliable savings products, all the more so with our ageing population. The UCITS label has become a great European success story, renowned for its transparency towards the investor, its reliability and performance even beyond Europe.

The objective of the fourth version of UCITS is to provide a tool box to ensure the competitiveness of the European asset management industry and to benefit European investors. It promises more choice, greater efficiencies and greater protection – at less cost. It will also reinforce the competitiveness of the UCITS label around the world.

The general principles of the legislation (Level 1 measures) have already been defined and approved by the European Parliament and the Council of Ministers. The outstanding details of the implementing measures (Level 2) will now be discussed, with an objective to finalise the text by July 2010. The directive will come into force in July 2011 after national transposition.

To make the most of the UCITS IV Directive, the industry will need to continue to work on a number of important issues, in particular to make fund processing simpler and more automated. More generally, both politics and industry have to address pension issues and the future role that UCITS investment funds could play to meet the challenges ahead. These challenges include: how to limit the risk of UCITS investments, how to ensure inflation-neutral returns and how to adapt the UCITS tax treatment for old-age pension provisions, in order to foster a savings culture. Industry and politicians will have to deal with these challenges collectively.

The path to the single European market may be long and complex but it is well under way and UCITS IV is a great milestone in its advance. I trust you find this paper interesting and enjoyable, and that it helps your understanding and decision-making for the future.

Dr. Wolf Klinz
Member of the European Parliament
Chairman of the Special Committee on the Financial, Economic and Social Crisis (Rapporteur for UCITS IV)

Executive summary

The purpose of the directive

The European Union's fourth directive on undertakings for collective investment in transferable securities (UCITS) is an important step towards the single market in financial services. It is likely to transform the asset management industry in the same way MiFID did for broker-dealers and investment banks.

Since their creation in 1985 and modification in 2001, UCITS funds have become a worldwide brand, renowned for their adaptability and dependability. However, significant enhancements were deemed necessary to ensure the competitiveness of the European asset management sector.

The new measures in the UCITS IV Directive will allow asset managers to operate freely throughout the region, with a single authorisation from one of the 27 European Union Member States. It should also facilitate cross-border fund distribution and provide greater protection for the investor.

UCITS IV aims to produce a more efficient and flexible European fund sector, with a lower overall cost. The new legislation will allow it to compete effectively with the US, for example, where there is a much smaller number of equivalent funds, which tend to be much larger in terms of asset value.

The Directive's five principal measures will facilitate fund mergers and master-feeder structures, allow centralised management of funds across Europe, and reduce the time asset managers have to notify regulators of new products. The management company passport, designed to eliminate the need to create additional company structures, is made enforceable. And a document with key investor information is designed to improve investor protection. It replaces the simplified prospectus.

Where are we today?

The Directive's Level 1 measures (legislative framework) were approved by the European Parliament and the Council of Ministers in January and May 2009 respectively. The European Commission is preparing implementation measures (Level 2), to be completed by July 2010. The Directive will have to be transposed into national legislation across all EU countries by 1 July 2011.

Market conditions have changed radically since the drafting process started in 2005. There has been a severe financial crisis in which the value of equities and other asset types has decreased substantially. There has been a shift from complex to simpler financial products, an aversion to risk and an appetite for opportunistic alternative investments. There is now strong pressure on asset managers who are experiencing declines in revenues as subscriptions slow, assets do not perform as well as expected, and costs increase.

New tools, new opportunities

A simple cost-reduction exercise is therefore not enough. Asset managers need to reposition strategically and rethink their whole expenditure base. They need to start thinking now about how best to use the new legislation.

UCITS IV provides an extraordinary toolbox to help asset managers reshape their fund strategy. It offers not only cost reduction potential but also new business opportunities: in cross-border fund distribution and leveraging the UCITS vehicle for fresh investment strategies.

How asset managers take advantage of UCITS IV will depend on their size, business model and strategy. Variations in European Union countries' local culture and tax systems also play a big part. Moreover, asset managers dealing with both UCITS and non-UCITS funds will have to consider similarities and inconsistencies between the UCITS and the alternative investment fund mangers (AIFM) Directives. This will allow potential regulatory arbitrage.

Asset managers therefore need to take key decisions on which types of investors and which markets to target, within and outside the EU.

Four of the five main measures are particularly relevant to exploiting UCITS IV's opportunities. The asset manager will be able to use any or all of these tools separately or in combination. Whilst there is some overlap, they tend to fall into two categories, as follows:

For example, a single-country asset manager can use the notification procedure to reduce set-up costs and time to market. Nevertheless, the subscription process needs to be as simple as possible, for example by having local and regional transfer agency services in place.

The same asset manager can also take advantage of the management company passport, which means it can create and manage funds without needing to set up another company in the country concerned. Alternatively, a master-feeder fund can be used to create another local fund, to keep costs down. The feeder and the master can both be managed by the asset management firm in the original country, using the company passport tool.

Opportunities to optimise cross-border distribution

- Streamlined regulator-to-regulator notification procedure
- Full management company passport
- Master-feeder fund structures

Opportunities for greater internal efficiencies

- Master-feeder fund structures
- Full management company passport
- Framework for domestic and cross-border fund mergers

A multi-domicile asset manager, which has set up fund structures in several countries, and distributes locally as well as cross-border, can rationalise the cost of its fund range organisation and/or distribution, by using the fund-merger tool. Alternatively, the fund manager can use a whole range of master-feeder arrangements, which offer great flexibility in terms of economies of scale. It is important to bear in mind the management of asset-servicing providers, where having both a global view and local expertise would be optimal.

How asset managers take advantage of UCITS IV will depend on their size, business model and strategy, as well as variations in local culture and tax systems

Master-feeder funds and the management company passport are also tools that will allow the asset manager to rationalise costs, along with fund mergers. There will also be opportunities to reduce operational risk depending on function and geography.

UCITS IV will impose new requirements in terms of organisational set-up, risk management and management of conflict of interest. These may increase costs, to ensure compliance, thus emphasising the need for organisational optimisation.

The role of the depositary

The new UCITS Directive's definition of the role of the depositary does not change from UCITS III. It will have to remain in the fund's domicile. However, there are now various initiatives to review the depositary's duties and liabilities, following varied national interpretation. In addition, the importance of the depositary has been highlighted in the light of recent major bank failure and fraud. The Commission's AIFM Directive is now requiring the use of a depositary for any type of fund, not only UCITS. These discussions may lead to an increase in the level of the depositary's liability, which would result in higher costs.

Implications for the industry

UCITS IV will affect all industry players, including asset managers, distributors, fund administrators, custodians and depositary banks. This white paper shows how and why, and seeks to address outstanding issues.

Introduction

The fourth incarnation of the UCITS Directive (undertakings for the collective investment in transferable securities) is an ambitious step towards the single European market in financial services.

All measures contained in the UCITS IV Directive are designed to reinforce the competitiveness of the European asset management sector. They will transform the fund industry, or buy-side, in the same way the Markets in Financial Instruments Directive (MiFID) did for the sell-side.

At the heart of the Directive is the concept of cross-border fund distribution and operations. It will allow asset managers to operate freely throughout the region, on the basis of a single authorisation from one of the 27 European Union Member States. It should effectively facilitate cross-border fund distribution. At the same time, the Directive is designed to guarantee greater protection for the investor.

UCITS IV should result in a more efficient, less costly funds sector for the European Union, and European investors should also benefit from all efficiency gains. Today's European fund industry is sub-optimal in terms of organisational structure. For example, there were 36,935 UCITS funds in Europe at the end of June 2009 (Efama). But the average size, USD 183 million, was far smaller than that of mutual funds in the USA: USD 1,269million (Investment Company Institute). Moreover, over 65% of European funds or sub-funds have net assets of less than EUR 50 million (Lipper FMI, April 2009), less than a third of the average value of an American fund.

UCITS IV aims

- Increase investor protection
- Increase industry efficiency
- Facilitate cross-border distribution
- Reinforce cooperation between supervisors
- Lower overall costs

UCITS - A proven success

- **75% of the net value of European investment funds are UCITS** (30 June 2009) **:**
  EUR 4,788 out of
  EUR 6,378 billion

- **UCITS posted net inflows of EUR 30 billion** during the second quarter of 2009

Source: The European Fund and Asset Management Association (Efama)

Specific measures include:

- A framework for domestic and cross-border fund mergers
- A fully functioning asset management company passport
- Master-feeder fund structures
- A new, streamlined notification procedure for cross-border distribution
- Key investor information, to replace the simplified prospectus
- Enhanced cooperation between supervisors

Asset managers, distributors, fund administrators, custodians, depositary banks – in fact, all industry players will be directly or indirectly affected by the UCITS IV provisions. This white paper sets out to explain how and why. It also raises outstanding issues and seeks to address these. Moreover, it examines the implications for non-UCITS funds, in the context of new legislative proposals: the Alternative Investment Fund Managers (AIFM) Directive.

UCITS main provisions

	1985 UCITS I	2001 UCITS III	2009 UCITS IV
Definition of organisational requirements, investment rules	●		
Simplified prospectus	○	●	
Wider definition of instruments	○	●	
Key investor information	○	○	●
Common notification procedure	○	○	●
Cross-border mergers	○	○	●
Cross-border master-feeder structure	○	○	●
Management company passport(1)	○	●	●

(1) Introduced in 2001, enforceable in 2009

Why does Europe's fund industry need another UCITS directive?

UCITS funds have enjoyed considerable success since their inception in 1985. They are considered as a global brand that ensures investor security and reliability. They have proved hugely attractive, not only in Europe but also in Asia, Latin America and the Middle East.

But despite this achievement, various assessment studies have highlighted the need for improvement. The original UCITS Directive's aim was to integrate the European market for investment funds, with greater opportunities for investors and wider business opportunities for asset managers. One of the main priorities of the Directive consisted of letting a fund authorised in one Member State be distributed in another, thus delivering progress to a single European market. The 'product passport' concept was therefore introduced.

However, when the Directive was transposed into law in the Member States, differing frameworks regarding cross-border marketing of such funds limited the uptake. There was also a restricted definition of officially endorsed instruments.

Thus in the early 1990s there were moves to revise the 1985 Directive and improve legislative uniformity across the European Union (EU). A second UCITS Directive was drafted but later abandoned for being both too ambitious and obsolete by the time it was ready.

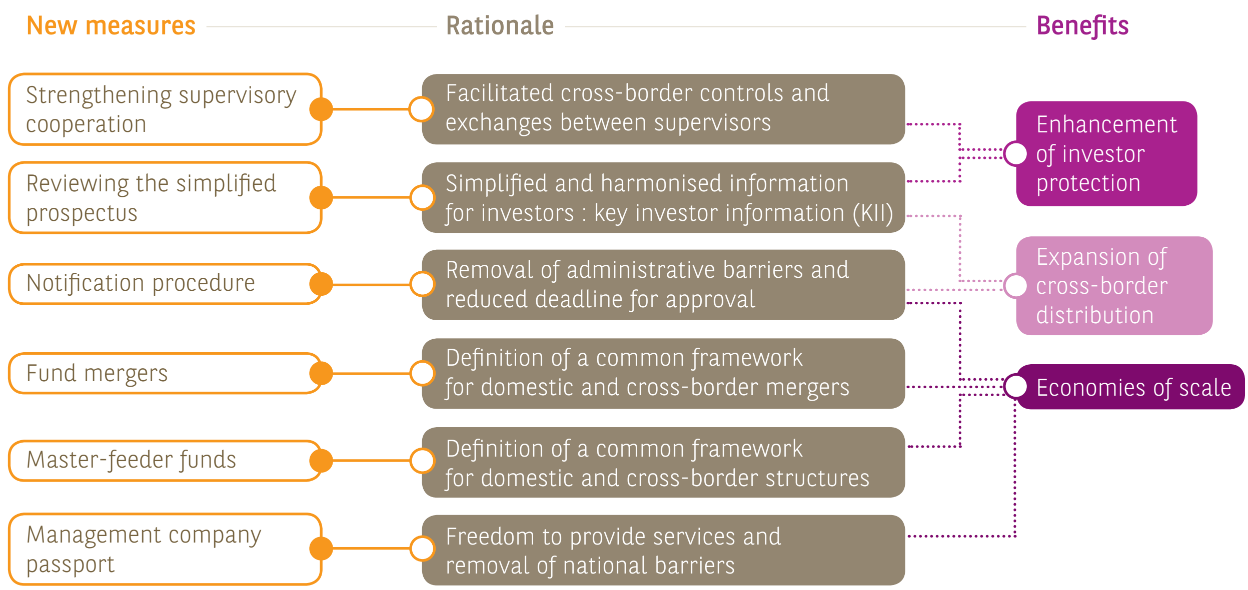
By 2001 the UCITS III Directive, with a set of significant amendments, was adopted. It introduced the simplified-prospectus concept, which was designed to give more accessible and comprehensive information to investors and to help cross-border UCITS marketing. At the same time, UCITS funds were allowed to invest in a broader range of eligible assets such as money-market funds, derivatives, index-tracking and funds of funds, as well as other UCITS funds. The new Directive also gave asset management companies a 'European passport' to function throughout the EU but this measure was not, in the end, enforceable, as there were no detailed measures governing implementation. And regulators continued to require asset managers to be located in the fund domicile.

Despite the improvements introduced since 1985, it was plain that substantial amendments needed to be introduced into the legal framework to adapt UCITS to twenty-first century financial markets. The 2001 measures failed to create real fund industry consolidation or to develop efficient fund processing, as regulatory cooperation was not sufficiently enforced.

In 2005, a European Commission Green Paper launched a public debate on the way the Directive could be adapted to meet the new challenges. This consultation process led to the largely collective conclusion that substantial improvements were necessary.

The new UCITS IV Directive should make for a more efficient and flexible single market: facilitating fund mergers and master-feeder structures, allowing centralised management of funds across Europe, reducing the time asset managers need to notify regulators of new products, and ensuring more uniform protection and lower costs for unit-holders. At the core of these measures is the removal of barriers to the free distribution of UCITS funds within the European Union.

UCITS IV measures and benefits



Part 1

UCITS IV tools

What you need to know

The origins of UCITS IV go back to 2005 when it was recognised that the UCITS legal framework would have to be amended to bring it up to date. But the process has accelerated over the last year, as shown in the figure on the next page

The European Commission issued its draft Directive in July 2008. There were a number of debates, especially on the asset management company passport. As there was a strong will to get the Directive adopted before the 2009 European elections, both the European Parliament and the European Council of Ministers managed to find a consensus on the content of the text, especially on the inclusion of the management company passport.

Therefore, the final version of the Directive (Level 1 measures), which defines the general principles of the text, was adopted on its first reading by the European Parliament in January 2009. It was also approved by the European Council of Ministers in May 2009.

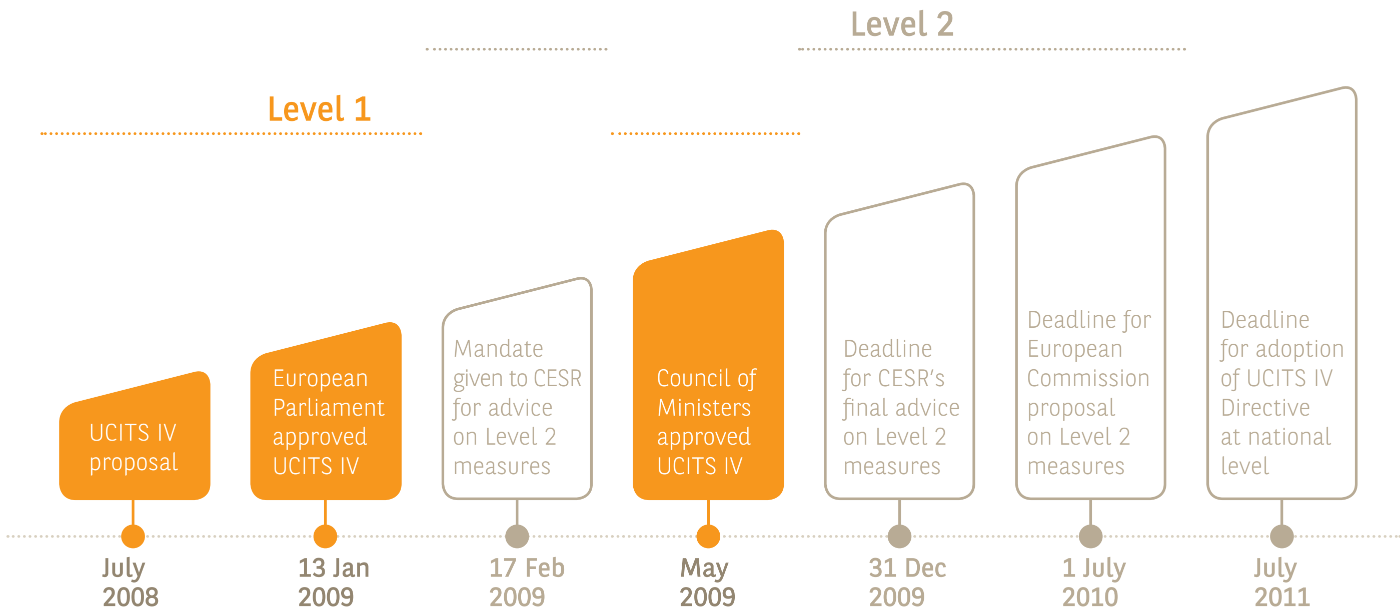
The Commission gave a mandate to the Committee of European Securities Regulators (CESR) to propose a large body of implementing (Level 2) measures(*). CESR presented its final advice at the end of 2009, following various consultations with the industry.

On this basis, the Commission will prepare implementation measures by 1 July 2010, and the Directive will need to be transposed into domestic legislation in all Member States before 1 July 2011. In some jurisdictions, working groups led by regulators have already been established to prepare national transposition.

(*) Lamfalussy Process:

- Level 1: Framework legislation, voted on by the Council and Parliament
- Level 2: Implementing measures for the Level 1 legislation, led by the Commission
- Level 3: Supervisory committees facilitating the convergence of regulatory outcomes
- Level 4: Enforcement of all EU measures, led by the Commission

UCITS IV timeline - Level 1



Note: the deadline for CESR's final advice on Level 2 measures was postponed to end 2009 to allow more time for consultation on master-feeder funds (the original deadline was 17 November 2009).

Key features

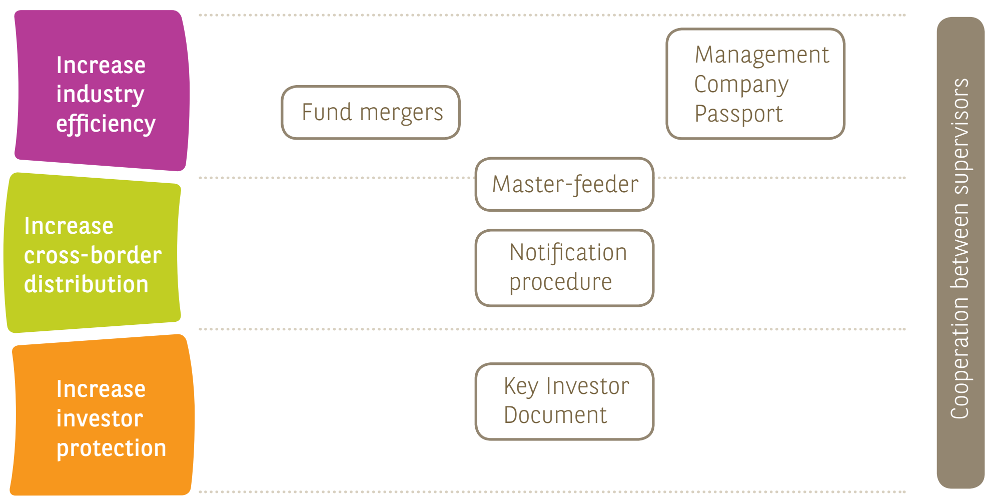
Following the conclusions of the expert groups' analyses, which were conducted to define the UCITS IV Directive's scope of revision, the Commission's objective was to enhance three main elements:

- Increase investor protection
- Increase industry efficiency and reinforce the competitiveness of European investment funds
- Facilitate greater cross-border distribution by lifting the brakes on the single European market. This gives the investor more choice and expands the asset managers' investor base

Level 1 measures (defining principles)

These priorities translate into five main measures, with an over-riding provision to reinforce cooperation between market regulators, as shown in the figure below:

UCITS IV main measures



Cross-border fund mergers

As part of the plan to increase industry efficiency, the Directive creates a legal framework to rationalise fund offering — facilitating both domestic and cross-border mergers of UCITS funds or fund compartments.

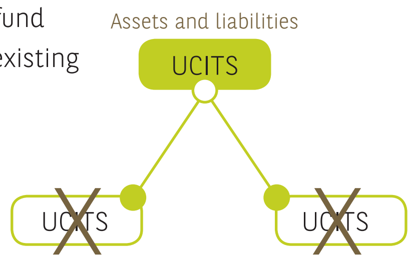
This can be effected by one of three techniques:

1 Absorption

The transfer of all assets and liabilities of one or several UCITS funds/compartments to another existing UCITS fund/compartment

2 New Fund

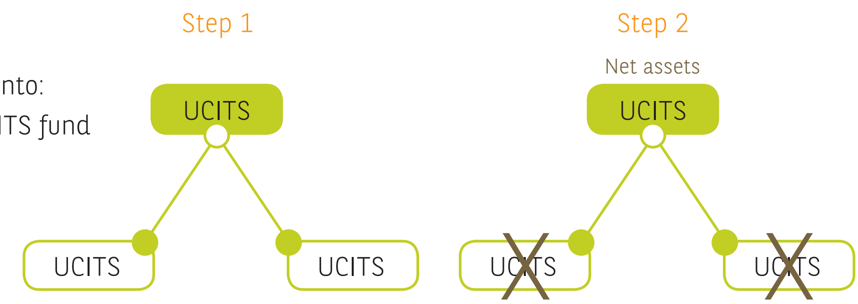
Creation of a new UCITS fund by dissolving previously existing funds



3 Amalgamation

Amalgamation of UCITS funds' assets into:

- The compartment of the same UCITS fund
- A new UCITS fund
- Another existing UCITS fund



The dissolving fund must submit any merger proposal by producing the following documents to its home regulator:

- The common draft terms of the merger
- A statement produced by each fund's depositary to validate the merger's compliance within the Directive's and the funds' rules
- An information letter for unit holders of both funds, containing the main features of the merger, the merger's rationale and its principal impact on each fund's unit holders

This is done with the following steps:

Step 0 — Production of all documentation required for the merger submission

Step 1 — Dissolving fund produces documents for the dissolving fund home regulator

Step 2 — Dissolving fund exchanges information with receiving fund regulator, which may require further information if necessary

Step 3 — Approval of the merger by the dissolving fund regulator within 20 working days of submission of documents, or justification as to why the merger request is rejected

The dissolving fund's regulator will communicate this information to the remaining fund's or receiving fund's regulator. Both regulators will be able to request further clarifying information. The whole authorisation by the merging fund's **regulator can only take a maximum of 45 working days**. If the merger request is rejected, the competent authorities have to justify their decision.

There must be appropriate and accurate disclosure to all unit holders of both the receiving and merging funds in the language of the fund's country or in English. Both receiving and merging fund holders will have the right to redeem funds without any additional charges during a period of 30 working days from the date of being informed.

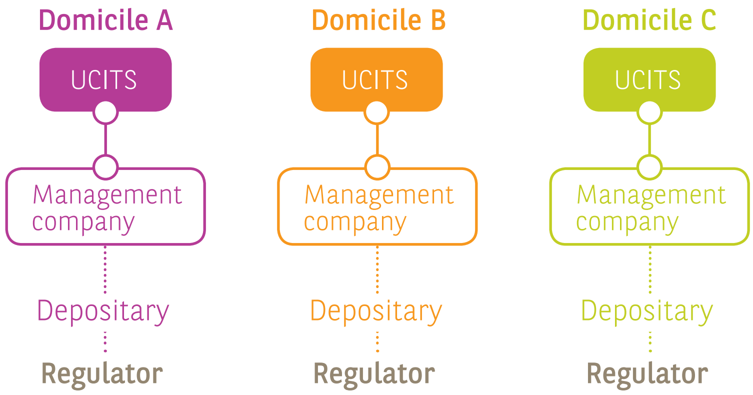
Merger-related costs should not be borne by the fund or the investors.

A major uncertainty, however, remains: what will the tax treatment be of the UCITS merger? This point was strongly underlined by the European Parliament as a potential impediment to the implementation of cross-border mergers. In return, the Commission intends to issue a recommendation to encourage harmonisation between Member States: to consider a fund merger as a non-taxable event.

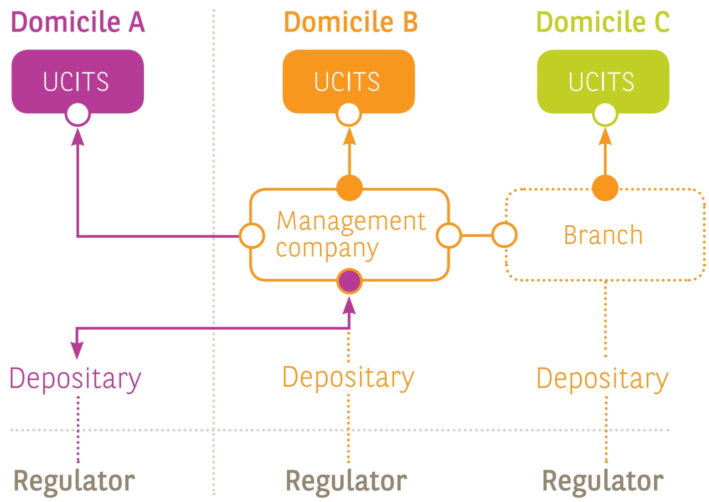
The management company passport

In another move to advance industry efficiency through economies of scale and consequent cost reduction, the UCITS IV Directive institutes and enforces the asset management company passport.

Before UCITS IV: multi-management company set up



Under UCITS IV: management company passport



A management company will be allowed to provide the full range of collective portfolio services to UCITS funds domiciled in another Member State, without needing to be fully established in that other Member State.

This can be done either on a full or on a remote basis, or by the establishment of a branch in the UCITS' domicile. In any case, there will be no obligation for the management company to locate any of its administrative and accounting functions in the UCITS domicile.

The UCITS fund's depositary must be domiciled in the fund's home Member State and it must comply with the latter's regulations. The asset manager must also comply with the Member State's rules of the fund's domicile for all aspects related to the fund. These include set-up, authorisation, valuation and accounting, investment policy and net asset valuation (NAV) calculations.

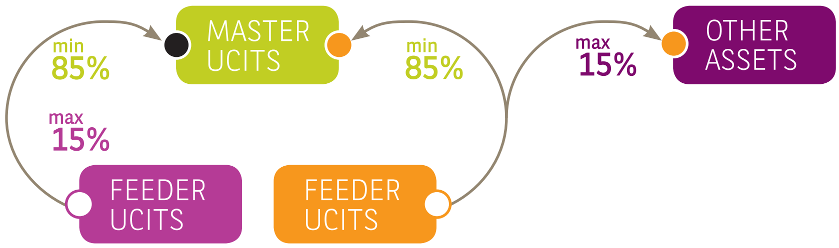
The supervisory duties between the management company's home regulator and the fund's home regulator will be split as follows:

1. The UCITS fund's home regulator will oversee all aspects relating to the fund's approval and its functioning

2. The management company will have to comply with its home Member State regulations, including company laws, rules of delegation and risk management procedures, promotional- prudential- and supervisory-rules, conflicts of interest and code-of-conduct rules. For example, the opportunities or constraints relating to delegating administrative and accounting functions (within the Member State, in the EU or outside), will depend on the flexibility of the asset management company's regulator

3. For all aspects relating to administrative and accounting functions, the management company will have to comply with the rules of the fund's domicile, including those for the NAV calculation

Master-feeder funds' investment structure



Master-feeder fund structures – pooling

Master-feeder structures are designed to boost industry efficiency, through economies of scale and pooling of master and feeder fund assets. Fostering cross-border funds distribution is an additional benefit.

Master and feeder funds will have UCITS status and operate within both a domestic and/or a cross-border framework.

The feeder fund must place at least 85% of its assets in units of a single master UCITS fund (or a compartment of a UCITS fund), and a maximum of 15% in other liquid assets or derivatives, provided the latter are only used for hedging.

The master fund must always be a UCITS fund and cannot itself be another feeder fund. It cannot invest in – or hold units in – a feeder fund. The investors in the master fund can be feeder funds and/or direct unit holders of the master fund.

The set-up procedure to follow is:

- **Step 0** – Production of all documentation required for approval
- **Step 1** – Feeder fund transmits documents electronically to host Member State regulator
- **Step 2** – Approval by feeder fund regulator, within 10 working days of submission of documents, or justification as to why the master-feeder structure request is rejected

The feeder fund's home regulator grants approval after having examined the following documents:

- An agreement between the master fund and the feeder fund (or where applicable, the management company of the fund) or an internal code of conduct if the master and the feeder funds are managed by the same company
- An information-sharing agreement between the auditors and a separate one between the depositaries
- A feeder fund prospectus that includes brief information on the master fund

In addition, all feeder-fund commissions or investment results in the master fund must be retained in the feeder fund and not benefit the fund manager. There must be measures to prevent market timing activity and arbitrage between master and feeder funds.

Regulator notification procedure

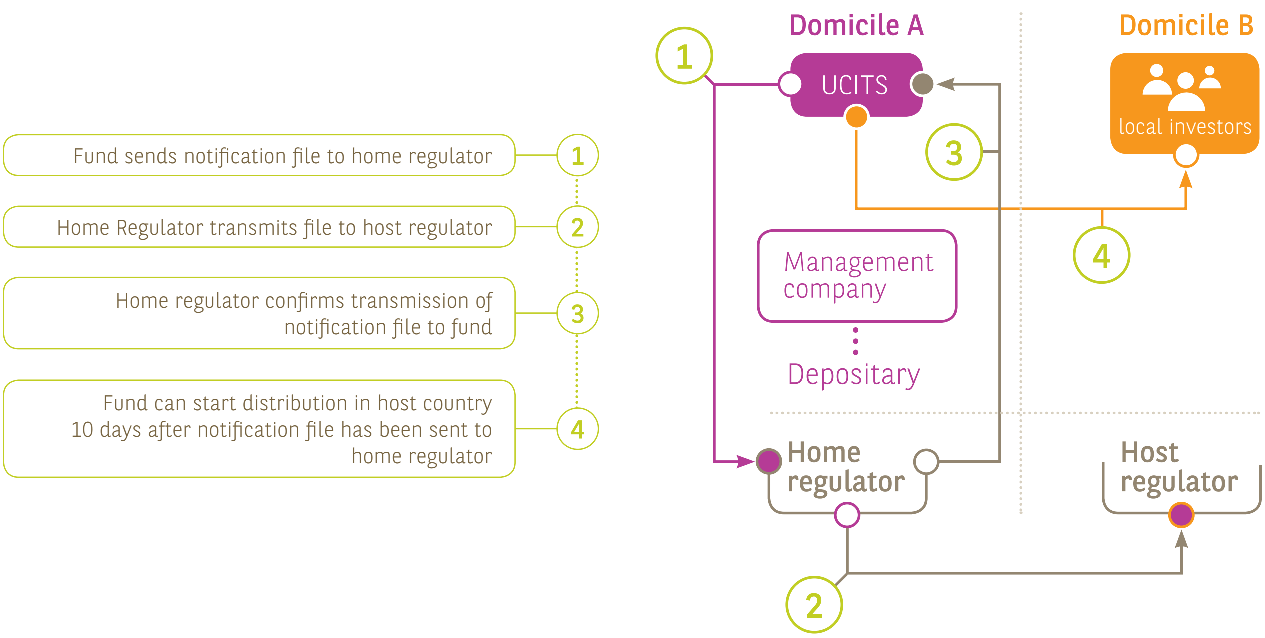
At the moment, the procedure to distribute funds on a cross-border basis is extremely long and cumbersome. Thus, in another move to take away administrative obstacles and delays to cross-border distribution, the Directive introduces new rules to make the notification procedure simple and quick. The aim is to reduce the time-to-market and decrease costs.

The procedure (see figure) requires the UCITS fund to submit a notification letter to its home regulator, which must include items about the fund, in particular the fund's proposed marketing arrangements to the fund's home Member State regulator. It should be written in the local language or English (except for key investor information which must be provided in the language of the distribution country).

Exchange between regulators is to be electronic and the home regulator's approval process can take a maximum of ten working days. The asset manager can actively market its fund in the distribution country within ten days, as soon as its home regulator has confirmed transmission of the notification file to the host regulator. The host country regulator will check the file on reception. However, distribution may already have started, at the asset manager's risk. After ten days, the host regulator will not be able to request further information and/or additional documents to check the notification file. The notification file is the only requirement.

The distribution country's regulations will still apply for all documentation to investors.

Notification procedure



Key investor information

In order to increase investor protection through improved cost disclosures, the simplified prospectus, which was deemed to be of limited use to investors and unnecessarily costly for the industry, will be replaced.

The asset management company will now have to produce a two-page document with 'key investor information' (KII) in a non-technical style, in the language of the distribution country. It must be comprehensible and allow the investor to make comparisons, so it must be clear, understandable and not misleading.

The management company has to ensure this document is provided to the investor whether the sale is direct or indirect. It constitutes a pre-contractual agreement on the part of the asset manager. It will become contractual only if the investor subscribes to the fund.

The key investor information (KII) must include:

- Fund identification
- Description of the investment policy and fund objectives
- Past performance, risk/reward profile
- Direct and indirect costs
- Risk/return fund profile, especially highlighting the risk related to the investment type

The KII is a document that may be extended to other investment or savings products, for example to unit-linked life insurance, to facilitate comparison.

UCITS supervision

In a further bid to remove administrative hurdles and delays, and to ensure all tools can be applied, the new Directive introduces overall measures to improve cooperation between Member State supervisors.

For example, there are implementing measures such as on-the-spot verifications and investigations, and a procedure for information exchange between regulators.

Thus, regulators can exercise supervisory and investigative powers directly, in collaboration with other authorities, via delegation or through the judicial system.

The effectiveness of this supervisory collaboration is essential for the success of all other measures and to avoid any additional requirements at national level.

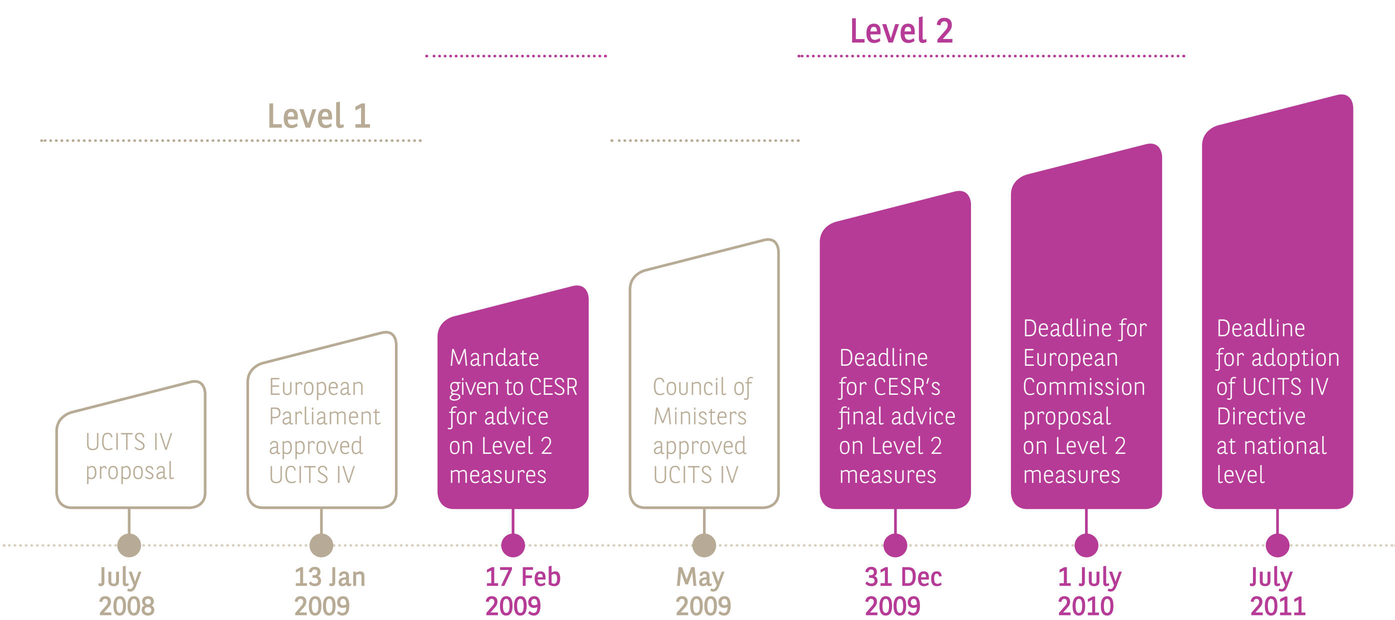
Next steps: Level 2 measures (implementation)

In order to meet the strict deadline, 1 July 2010, on the adoption of several implementation (Level 2) measures, (see figure below) CESR launched the focused consultation phases where it will provide detailed technical advice to the Commission. This consultation phase was completed on 17 November 2009.

CESR published its advice on all aspects of the directive at the end of 2009.

The Commission will submit a legislative proposal presenting all detailed implementation measures, to the European Parliament, which will verify that Level 2 measures are in line with the Level 1 principles. It cannot undo the Level 1 work.

UCITS IV timeline - Level 2



UCITS IV

CESR has launched various consultations. It first issued a **call for evidence** on Level 2 measures in mid February 2009.

CESR also launched a **technical consultation** on the KII in March 2009 (the deadline was 15 May 2009). It covered three topics:

- Risk and reward profile
- Past performance
- Costs

At the beginning of July 2009, CESR launched a **second set of consultations**, which addressed the following:

- Level 2 measures related to the management company passport
- Second consultation on the KII
- Consultation on fund mergers, master-feeders and notification

Following this broad consultation phase, CESR issued its technical advice at the end of 2009, as follows:

- CESR recommends maximum alignment with MiFID provisions in regards to asset management company organisation, conduct of business rules, best execution, and so on

- CESR also recommends strengthening provisions in terms of risk management for asset managers. For example, they should not only rely on counterparty pricing for their OTC derivatives but should use additional external sources or develop inhouse expertise

- CESR confirmed the format and content of the KII, and in particular confirmed the requirement for a synthetic indicator to give information on the risk/reward profile of the fund

Other initiatives affecting the EU fund industry

In parallel, the European Commission has issued a consultation on UCITS **depositaries** to review their duties and levels of responsibilities, drawing lessons from the recent events that resulted in a high level of market turbulence (for example, the Lehman Brothers' default and Madoff fraud).

The Commission also issued, in April 2009, a proposed directive for **alternative investment fund managers (AIFM)**, which intends to cover all non-UCITS funds. This new directive is currently being discussed at the EU Council and the European Parliament and is planned to be adopted in July 2010 (Level 1 measures), after thorough review and discussion.

- For asset managers who manage both UCITS and non-UCITS funds, similarities and inconsistencies between the AIFM and UCITS Directives will need to be taken into account when forming their strategy, both in terms of product and operational organisation. For example, the degree of harmonisation between UCITS and AIFM requirements (human resources, systems) in terms of organisational requirements, risk management and conflicts of interest, may lead to additional costs for asset managers

- The decision on the duties and level of responsibilities of the depositaries may also lead to increased costs for the industry

In conclusion, there are a large number of measures that may transform the asset management environment and affect all parts of the value chain. UCITS IV is one of the key pillars.

UCITS IV is effectively a toolbox for asset management companies. What are the potential effects of each tool? Which tools will asset managers prefer, and how can they be used? We look at these issues in Parts 2 and 3.

The new context

The drafting process of UCITS IV started in 2005. Since then market conditions have changed considerably. We have experienced a financial crisis sparked off by the subprime mortgage crisis in America. This has led to a severe decline in the value of stock market shares and most other asset classes around the world. There are now several new trends arising:

- A shift away from very complex to simpler financial products such as money-market funds, guaranteed funds and exchange-traded funds
- An aversion to risk
- Targeted opportunistic alternative investments
- The use of the European Union's UCITS vehicle for simple alternative strategies

At the same time, there is strong pressure on asset managers who are seeing a decline in revenues as subscriptions slow, assets are not performing as well as expected, and costs increase.

A simple cost-reduction exercise is not enough. Asset managers now need to reposition strategically and to rethink their whole cost base, to support the business of tomorrow.

UCITS IV constitutes an extraordinary toolbox to help asset managers reshape their strategy with regards to UCITS funds. It offers not only cost-reduction possibilities but also several new business opportunities, such as developing cross-border funds distribution or leveraging the UCITS vehicle for new investment strategies.

Part 2

Opportunities to optimise cross-border distribution

How asset managers take advantage of UCITS IV will very much depend on their size, business model and strategy, as well as variations in Member States' local culture and tax systems. Asset managers dealing with both UCITS and non-UCITS funds also have to consider similarities and inconsistencies between the AIFM and UCITS Directives. This will allow potential regulatory arbitrage.

Asset managers therefore need to take explicit key decisions on which type of investors and which markets to target, first within and then outside the EU.

The UCITS IV Directive provides a toolbox for asset managers to optimise their fund product range in terms of client and country, particularly through new rules on:

Cross-border distribution:

- Streamlined regulator-to-regulator notification procedure
- Master-feeder fund structures
- Full management company passport

At the same time, the following tools will allow the asset manager to minimise costs through:

- Full management company passport
- A framework for domestic and cross-border fund mergers
- Master-feeder fund structures

We shall now describe the elements of the legislation through illustrative cases. The following examples show two extremes: a single-country asset manager seeking European expansion, and a pan-European asset manager seeking organisational rationalisation.

Case 1: Single-country entrepreneurial asset manager, looking to expand across Europe

This would be the case of an asset manager seeking to expand the distribution of its funds from a single market to the rest of Europe. For example, a local fund in one country, eg the United Kingdom (UK), has a single country investor base in the UK, and wishes to attract investors from outside its domestic market, for example from Italy.

Today, there are several obstacles to expansion. There is a lengthy time to market for cross-border distribution. Furthermore, it is still costly to set up a local fund in another country as it is necessary to use a local asset management company to cope with local organisational requirements.

UCITS IV allows for the creation of a lighter structure, where the asset manager will be able to use any or all of the following tools, separately or in combination:

Case 1: notification procedure

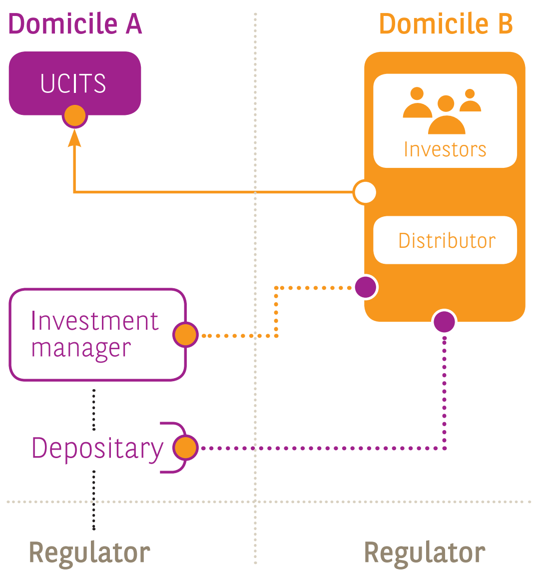
This is likely to be the most popular measure as the easiest set-up is to market the local fund in another country. The simplified notification procedure will provide a faster time to market and a less costly set up.

The current procedure is lengthy and costly. Costly because it is fully driven by the asset manager who incurs administrative and translation expenses dealing with both the regulators of the home and host countries. Lengthy as there is a two-step process that can take up to several months. The home regulator first has to authorise the fund for cross-border distribution (the response time is undetermined). Then the host regulator must approve, within two months, the marketing of the fund in its territory.

The new notification procedure will facilitate cross-border distribution of an existing domestic fund. The process will be easier (the asset manager only has to transmit the completed file to his home authority), faster (ten working days maximum) and harmonised across all markets (the completed file will be the same wherever the host market is and no additional documents can be requested by the host regulator).

In our example, this new measure will allow the UK manager to distribute its UK fund in Italy faster and at a reasonable cost. Before all this, however, the asset manager must assess how attractive a product a UK fund is to Italian investors, given the tax and cultural aspects. In any case, this process allows the asset manager to test the appetite for foreign investors.

Cross-border distribution: using notification procedure



Case 1: management company passport

This replaces the need to have a local management company to introduce a new product as a local fund. Moreover, the asset manager's holding company can relocate while its investment manager does not have to. There is therefore no need to have two asset management company structures, thus reducing cost.

If the asset manager decides that a local fund is more appropriate to meet a foreign distributor's needs or is more appealing for the targeted investor base, the current requirement to have a management company structure in the fund's country of domicile might result in delays. This is especially the case during the early years of the fund. With the introduction of the management company passport, the set up of a local fund can be done remotely and hence become a more realistic approach for a smaller player.

The management company passport applies to legal structure and administrative matters (investment management, distribution, central administration), and not to the delegation of cross-border portfolio management.

Our UK asset manager could for example set up an Italian fund that it will manage from London.

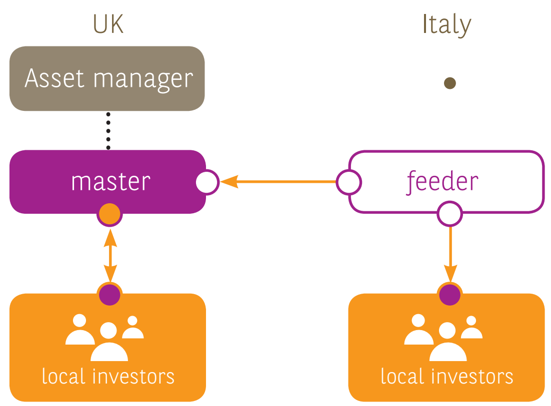
Case 1: master-feeder fund

Instead of creating a new local fund from scratch or duplicating an existing fund, the master-feeder tool can be used in two ways:

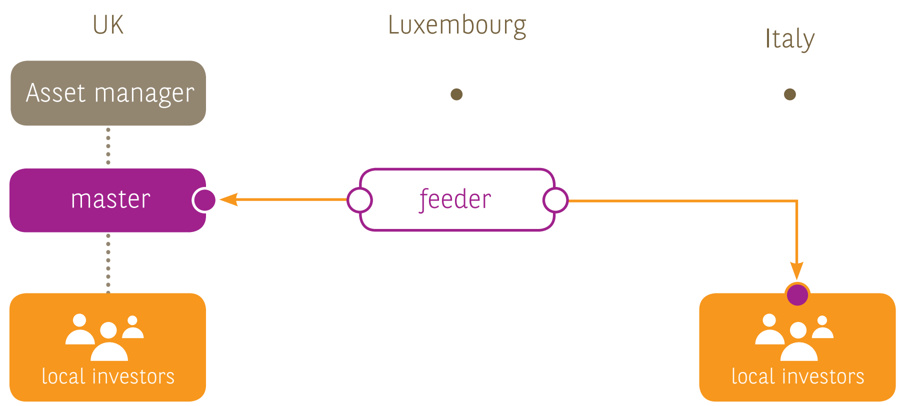
- Where a local fund is already in place and is marketed to local investors, it can become the master while other domestic funds become feeders. The measure limits management costs by eliminating the need to have two fully constituted funds
- As the main fund is in the home country (the UK) it can be designated as a master fund, which can then be used by various feeder funds around Europe (for example Italy, France, Spain)

In our example, the UK Manager could use its UK fund as master and create an Italian fund as feeder. Alternatively he could also create a feeder fund in Luxembourg invested in the UK master, and distribute this Luxembourg feeder fund in Italy using the streamlined notification procedure.

Master-feeder structure (option 1)



Master-feeder structure (option 2)



Case 1: decision criteria

The choice of options will depend on various factors, a key one being the type of investors the asset manager targets, as follows:

- Cultural aspects of each target country market
- Tax differences
- Ease of access to the fund
- Ease of subscription/redemption
- Distribution channels and investor types: retail, institutional, insurance companies
- The asset manager's:
  - Marketing strategy and image
  - Positioning as local or global player
  - Operating Model (operations, IT, legal, finance, sales, relationship management, distribution channels)
  - Cost sensitivity or profitability
  - Willingness to outsource operations, for example to low-cost countries
- Regulatory arbitrage (supervision, management companies' delegation rules, human resources)

There is an additional requirement: the asset manager must make sure it has the appropriate distribution channels in the new market. It needs to choose who will sell the product to the targeted investors. Therefore, decisions will have to be made to ensure there is a sales force on the ground, via a distribution network in any new market the asset manager targets, for example by appointing a local distributor.

At the same time, the asset manager must ensure the subscription/redemption process is facilitated. It is important for the asset manager to make sure its subscription process is as simple as possible, for example by having local and regional transfer agency services in place. Such processes vary greatly across European countries, and local expertise is needed to implement set-up. There are options to make this simple. These include the setting up of regional transfer agency agreements, working with a network of domestic transfer agents.

Case 2: Pan-European asset manager seeking to rationalise its organisation or distribution

This case applies to an asset manager who already has a pan-European strategy using multiple fund products in several EU countries. It distributes locally as well as cross-border (offshore). UCITS IV presents an opportunity to optimise its pan-European strategy by reducing the cost of its fund range organisation and/or distribution.

Today, such an asset manager may have to create local or domestic funds in, for example, France, Spain and the UK. For some other countries, say Italy, Germany, non-EU states and markets in Asia and Latin America, they may, for example, market a Luxembourg fund.

This situation has created a large number of, most likely, duplicated funds, a high proportion of which are small. It has also resulted in the creation of multiple asset management companies: one per country. The situation has been exacerbated when large asset management groups have merged.

UCTIS IV offers a number of new opportunities: greater flexibility in economies of scale in both financial management and general administration, as follows:

- Fund Mergers and notification procedure: these tools can be used to convert say three duplicated funds in different EU countries into one fund distributed in three states. This is provided that the remaining fund is suitable for these three markets' investors, in terms of: tax, culture and reputation. A consequence of such a strategy may be a concentration of funds in one or perhaps two countries. As most pan-European asset managers have developed a presence in Luxembourg, it is possible that fund mergers may concentrate in Luxembourg

- Master-feeder structures: the asset manager can select one fund to be the master and the other, duplicated funds will transform into feeders. The choice of the domicile of the master fund will depend on the proximity to the asset manager's operational and decision-making centres, tax considerations, and general suitability for investors

Case 2: master-feeder fund scenarios

The master-feeder structure offers considerable flexibility, with a whole range of scenarios, as illustrated in the examples below.

The domicile of the feeder funds will depend on their suitability for the targeted investors, either in a cross-border distribution centre or in the domestic country of the targeted investors.

Scenario 1

Master fund in asset manager decision centre
eg master fund in the UK

The asset manager transforms its best cross-border funds into masters, by creating several local feeders, principally for retail distribution.

Scenario 2

Master fund in asset manager decision centre and feeder in cross-border distribution centre
eg master fund in the UK or France

One feeder fund in Luxembourg or Ireland is used for cross-border distribution in all EU countries. This is a simple version of scenario 4 below.

Scenario 3

Master fund in cross-border distribution centre
eg master fund in Luxembourg

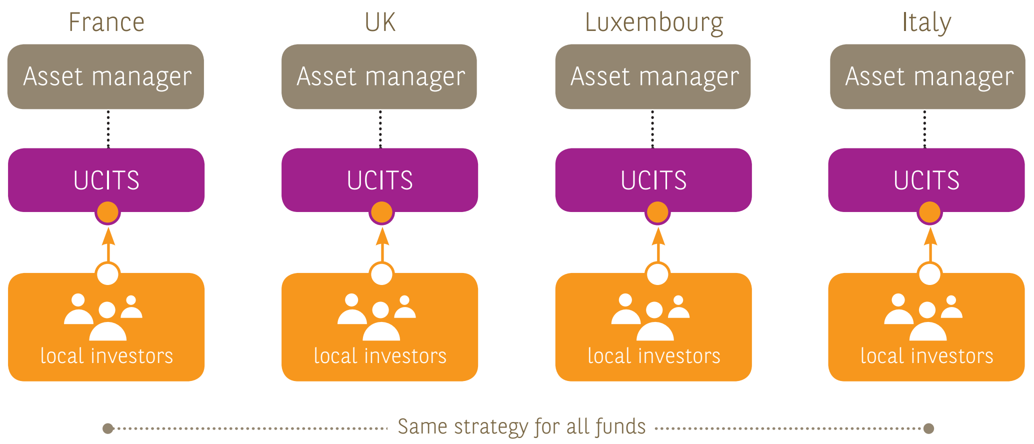
The asset manager turns its Luxembourg fund into a master for cross-border distribution. This fund may also be used for distribution outside Europe, eg Asia, and other local feeder funds when it is appropriate for local investors.

Scenario 4

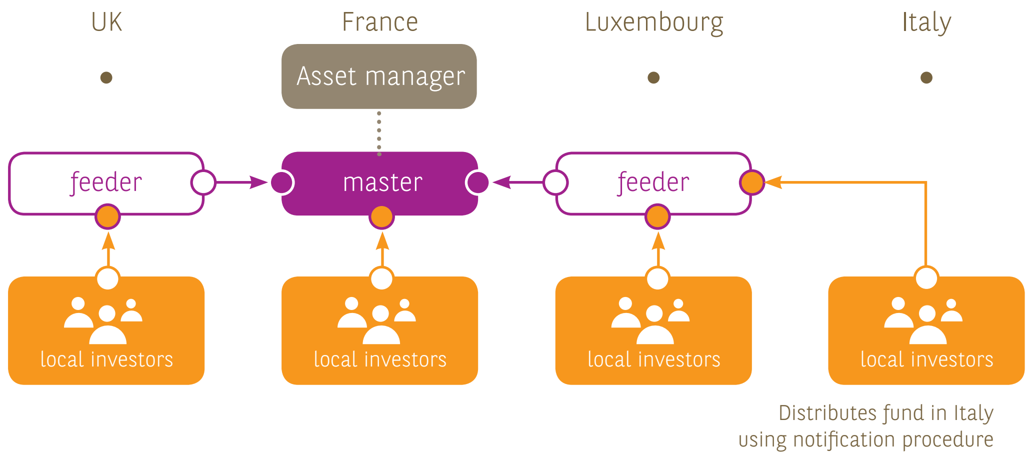
Master fund - combination of scenarios 1 and 2
eg master fund in the UK, France or Germany

Feeder funds for distribution in main countries. One feeder fund in Luxembourg or Ireland for distribution in other markets, for example Italy, as well as outside the EU.

Today: before UCITS IV
(example set-up)



Tomorrow: with UCITS IV
(example set-up)



Further illustration of a master in the asset manager's decision centre and a feeder in a cross-border distribution centre (scenario 4)

Scenario 4 is perfectly suited to countries where asset management companies are already in place.

For example, German asset management companies (KAG) often have subsidiaries in Luxembourg and/or Ireland. These administer local funds in each of these countries using the same investment strategy. This is because the different distribution channels and targeted investors (in Germany, the rest of Europe, as well in Asia) require funds to be in internationally recognised fund markets. There are also historical reasons such as mergers and acquisitions of asset managers.

With UCITS IV, these German asset managers have an opportunity to streamline their asset management and fund administration. This can be done while keeping or even expanding their worldwide distribution strategy, by setting up a master fund in Germany and feeder funds not only in Luxembourg and Ireland, but as well in all other EU Member States.

The asset manager could administer a bigger pool of assets (the master fund), streamline its communication and reconciliation flows via one single depositary (of the master fund). The company could therefore get better conditions for the settlement of its transactions, the safekeeping of its assets and other value-added products such as client reporting and performance analysis, securities lending programmes, OTC derivatives trade support and transition management (see Part 3).

Investors all over Europe, however, are now able to subscribe to a local fund in any country. In the past they only had the option of subscribing to a German, Luxembourgish or Irish fund, in addition to the funds in their own country.

Here is another example of a master fund in the asset manager's decision centre and a feeder in a cross-border distribution centre (scenario 4). An asset management company has funds domiciled in six European countries: Luxembourg, Ireland, the UK, France, Germany and Austria.

It wants funds for global distribution, including outside the EU, so it decides to merge the funds domiciled in Luxembourg and Ireland, but to keep separate funds in the UK and France, for cultural, tax, brand recognition and/or local distribution considerations. The manager does not see a need to keep local funds in Germany and Austria, so these become distribution markets only.

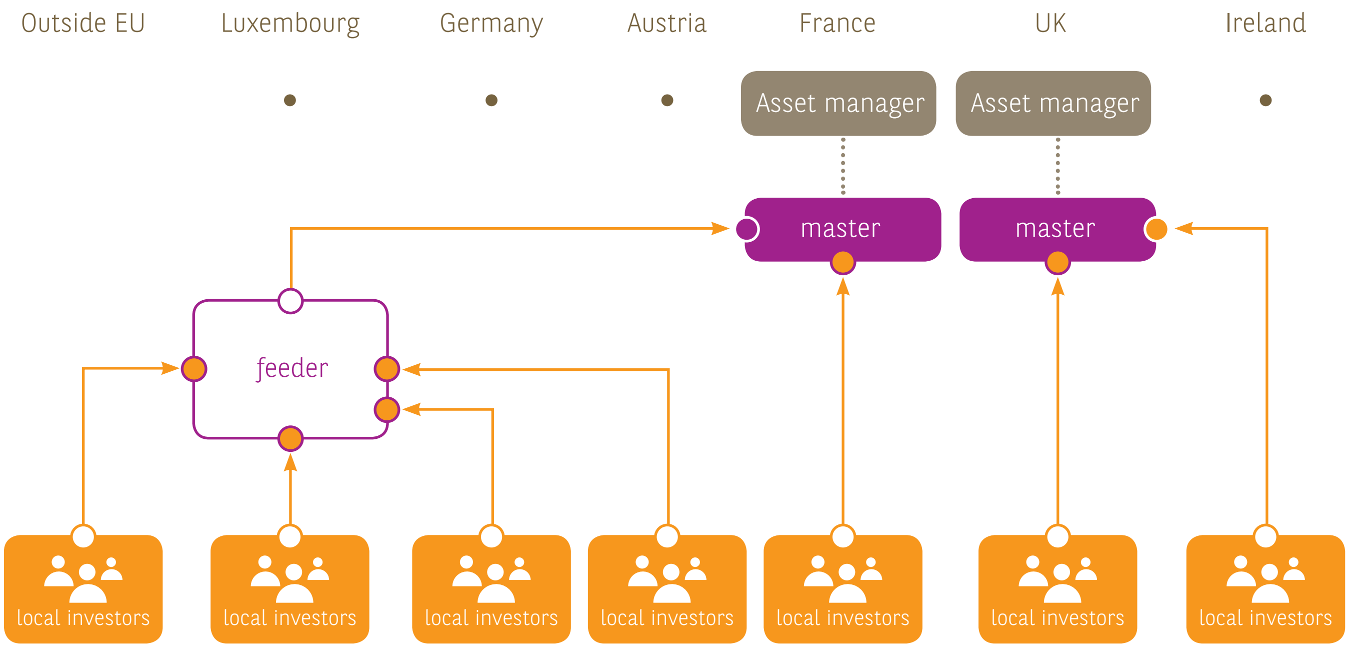
However, there are local tax treatment issues in Germany and Austria, as well as in other countries, that may create disincentives (eg Plan d'Epargne en Actions (PEA) eligibility in France: solvency ratios for institutional investors investing their own money). Being taxed at the maximum rate would create a commercial disadvantage. The question arises, where should the tax calculation on the NAV come: at the master fund in France or the feeder fund in Luxembourg. This question will be addressed by national jurisdictions, which may lead to some artibrage opportunities.

Case 2: other success criteria

For a pan-European asset manager to be successful in taking advantage of the various UCITS IV tools, it will need to ensure that the subscription/redemption processes are efficient and simple, and that the distribution channels will have to be streamlined to support these rationalisation moves.

Master-feeder structure with cross-border and global distribution

(example set-up)



Part 3

Opportunities for greater internal efficiencies

This section analyses the main tools that will be available to management companies to reduce their costs and consequently make their internal organisation more efficient. UCITS IV will impose new requirements in terms of organisational set-up, risk management and management of conflict of interest. These may increase costs, to ensure compliance, thus emphasising the need for organisational optimisation.

The issues in Part 3 here largely apply to the pan-European asset manager example, as defined in Part 2. But they also apply to those asset managers wishing to expand across the EU, as it relates to decisions that need to be made in terms of organisational set-up across multiple markets.

As previously mentioned, asset management companies will have the opportunity to enhance fund distribution strategies in the European single market by individually selecting the most appropriate measures offered under the UCITS IV Directive.

At the same time management companies will have to consider how UCITS IV tools will help them improve their cost structures by allowing them to achieve some economies of scale. This corresponds to the second main objective of the Directive and most UCITS IV measures have been introduced in this respect:

- Management company passport
- Fund mergers
- Master-feeder fund structures
- Notification procedure

As a consequence, management companies will have to review their internal organisation, notably in terms of location for their own structures, their funds and/or their asset servicing providers. These choices will mainly be driven by their distribution policy.

Having identified its distribution strategy, the asset manager can rationalise its organisation using the UCITS IV toolbox, in two ways:

- Reducing operational risk by having a more streamlined organisation
- Reduce costs

Fixed costs

Fixed costs can be reduced through economies of scale: fewer funds but larger portfolio sizes and fewer fund domiciles. Both cross-border mergers and master-feeder structures within a single European framework should offer great opportunities to simplify and consolidate fund operations. This will be achieved by rationalising product ranges designed to serve the management company's distribution strategy.

The high fixed-cost base of a number of asset managers can also be optimised by transforming some of them into variable costs, through outsourcing of non-core administrative functions. The benefits of the cost-reduction measures are examined below.

Fund mergers and master-feeder structures

The European Commission's analysis concluded that Europe is very costly in terms of fund processing, for two principal reasons:

- As explained in Part 1, the European funds industry is characterised by a huge number of small funds when compared with the US. This situation mainly results from the difficulty in Europe of distributing funds on a cross-border basis due to local constraints. Management companies are therefore obliged to replicate investment policies at local level

- There are no mechanisms in place yet in the EU that could favour economies of scale on a pan-European basis, through the pooling or amalgamation of functions applied to several funds with common characteristics. The obligation to maintain local structures in all Member States also prevents efficiency gains

- Number of UCITS funds in Europe, June 2009: 36,935 (Efama)
  Number of mutual funds in USA, June 2009: 7,903 (ICI)
- Average UCITS size: USD 183 million
  Average US mutual fund size: USD 1,269 million
- Over 65% of European funds or sub-funds have net assets of less than EUR 50 million
  (Lipper FMI, April 2009)

Fund mergers

The main measure introduced to address the first issue is fund mergers, for domestic and cross-border needs. At the moment it is almost impossible to merge cross-border funds due to local differences and requirements imposed by national competent authorities, such as the different tax regimes. In some countries the fund merger is currently tax neutral; in others it is not.

This measure, through the provision of an appropriate framework, will allow management companies to restructure and rationalise their fund range by consolidating the assets of several funds in a larger single vehicle. The consequent reduction in fund numbers will potentially lead to cost reduction in the following areas:

The notification procedure will facilitate fund distribution throughout Europe, at a reasonable cost

- Fund management as the replication of similar investment policies will be replaced by the promotion of a single fund
- All administrative and accounting functions linked to the fund, as well as legal, domiciliation and audit maintenance costs. These can be performed for one fund only, instead of for several
- In addition, by managing a bigger pool of assets, asset managers may also benefit from better conditions for settlement of its transactions, safekeeping of its assets and other value-added products, such as securities lending or OTC trade support

In this respect, the simplification of the notification procedure will be essential as it will facilitate the distribution of a single fund throughout several Member States at a reasonable cost. Here, management companies will have to decide where it is advantageous to locate the remaining fund, to maximise its distribution policy according to the fund's attractiveness to investors, and the reputation of the financial centre.

For example, German retail investors are neutral as to buying a German fund, a Luxembourgish or an Irish fund. Therefore large German asset managers, which generally manage German, Luxembourg and Irish funds, are expected to concentrate their fund ranges in Luxembourg or Ireland. The funds domiciled in these countries are better positioned for successful worldwide distribution, including Asia and the Middle East.

Nevertheless the German asset manager will need to take another strategic decision: will it manage its Luxembourgish and Irish funds out of Germany by using the management company passport or will it continue to use its subsidiaries in Luxembourg or Ireland? A key driver will be the capacity of the fund-accounting platform used by the German firm to cope with German, Luxembourgish or Irish generally accepted accounting principles (GAAP). A potential solution would be to outsource the fund administration to a local or global service provider of fund administration and transfer agency services.

Master-feeder structures

To offer more flexibility in terms of product offering, the UCITS IV Directive makes it possible to set up master-feeder structures on a domestic and a cross-border basis. Once again, operating cost reduction should be possible at fund management level and for accounting and administrative functions, as these tasks will be performed mainly for the master fund. Even if the creation of feeder funds will potentially increase the number of funds, the corresponding treatment for feeder funds will be limited. And consolidation of some functions on common platforms is possible, although each fund must comply with local regulations.

For example, in the case of the German KAG described in the previous section (part 2, scenario 4), we believe the KAG fund administration department could considerably decrease its costs (by up to two-thirds) because only the master fund requires considerable detailed accounting procedures. The feeder fund is a simple one, which does not need a great deal of resources to administer, compared to the fully fledged local funds. Cost reduction will thus be possible, in particular if the same administrative and accounting service provider supports both the master and the feeders.

As with the fund-merger tool, the introduction of the management company passport can be complementary to the implementation of master-feeder structures to reduce costs. Because there will no longer be any obligation to maintain local operating structures in all Member States where funds are domiciled, management companies will be able to resort to common operating platforms, for investment and risk management, but also for some administrative and accounting functions.

As will be the case with the fund-merger measure, management companies will have to decide where the master fund and feeder funds will be domiciled. Once again, distribution policy will be the key driver for this decision. The location of asset management and broad financial management expertise, concentrated at the fund manager's decision-making centre, as well as the availability of human resources, will also influence the final model retained for the implementation of master-feeder structures. (The asset management function itself can already be outsourced to asset managers even outside the EU.)

The management company passport

The management company passport will provide the chance to remove barriers to the provision of cross-border services within a single European market. It will no longer be necessary to have a capitalised structure in all Member States where funds are domiciled. The management company will have the freedom to provide services on a remote basis.

This new flexibility will represent a great opportunity to concentrate activities and resources in a limited number of locations. Consequently, asset managers will save costs and achieve economies of scale. This applies not only to operational services but also to all potential associated control, compliance and risk management functions. It should be noted however that under level 2 measures, asset managers will most likely be required to comply fully with MiFID organisational and conduct-of-business rules. This may increase cost for asset managers in some jurisdictions where full MiFID compliance was not previously required.

In such a context, management companies will have to consider how they can adapt their existing organisation and what the best approach will be to restructure their internal resources and operating systems.

The passport applies to legal and administrative matters (it does not prevent the use of cross-border delegation of portfolio management)

The management company passport applies to the legal structure and to all functions of asset management. It does not prevent the use of cross-border delegation of portfolio management.

As for mergers and master-feeder structures, distribution policy priorities will be key elements in designing the target model. Management companies will also have to take into account factors that will have some influence on their own functioning and/or on the funds themselves:

- Existing set-up in particular for staff concentration and costs
- Tax regime
- Brand and reputation
- Expertise in terms of asset management supervision
- Flexibility of local regulations (delegation rules)

The flexibility of national legislation in terms of delegation rules is an important factor. Indeed, although investment management functions are allowed to be delegated on a cross-border basis, it is not always the case for other asset management functions, such as administrative or accounting tasks. There is no move towards European harmonisation on this matter as part of the UCITS IV Directive. The asset manager will have to comply with the delegation rules of its home Member States, which will offer some opportunities in terms of regulatory arbitrage. This factor, though not necessarily the most important, will also have to be taken into account in the choice of where to domicile the asset management company.

In some jurisdictions the asset manager may need to select a service provider in the same jurisdiction, although it may manage funds in a number of different European markets. To limit this constraint, the asset manager would have to privilege service providers with a pan-European footprint, able to serve all types of European funds.

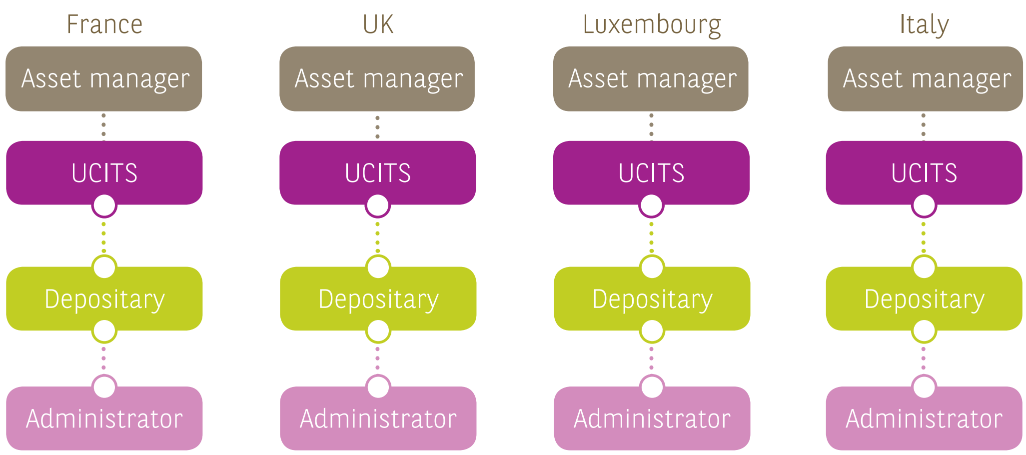
Administrative functions

The asset manager has an opportunity to use its securities services providers in a more efficient manner. This is linked to reducing costs through having fewer funds and/or to using a master-feeder structure.

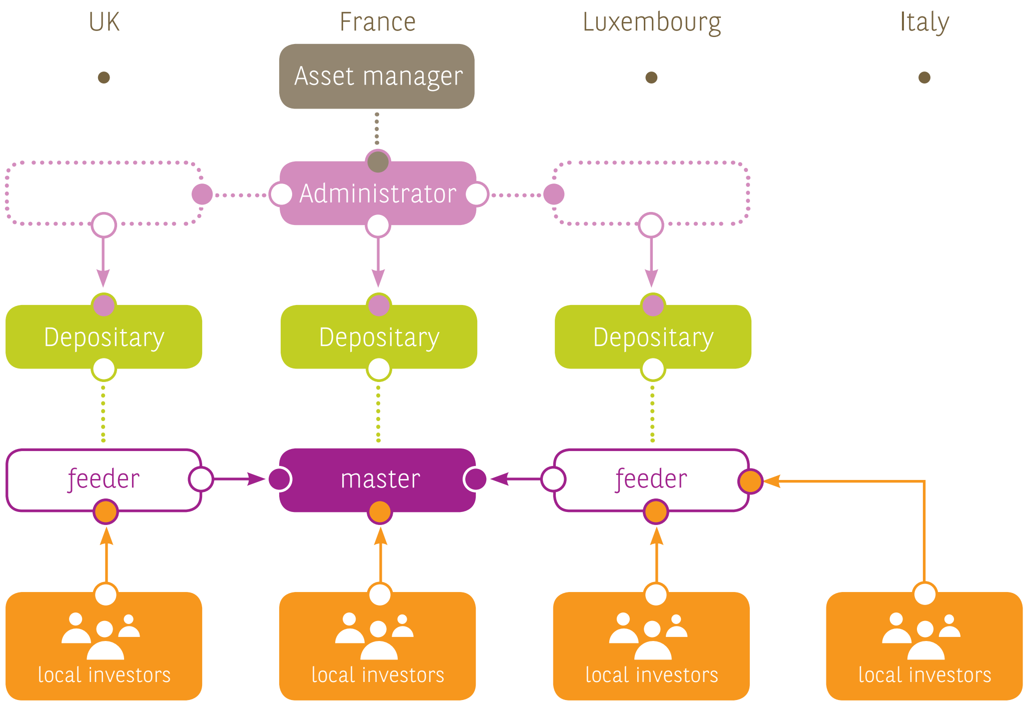
A single pan-European asset-servicing provider can be used effectively to support the variety of models selected by the asset manager and the streamlined fund range, regardless of their jurisdiction. Such a provider will also simplify and optimise costs for master-feeder fund structures, and allow concentration of the activities with one provider of custodian, depositary and central administration services within the same group.

Local expertise will continue to be advisable as accounting rules, tax treatment and tax regulatory reporting will remain country-specific. The optimal approach would be to use a provider with a combination of local and pan-European capabilities.

Today: before UCITS IV
(example set-up)



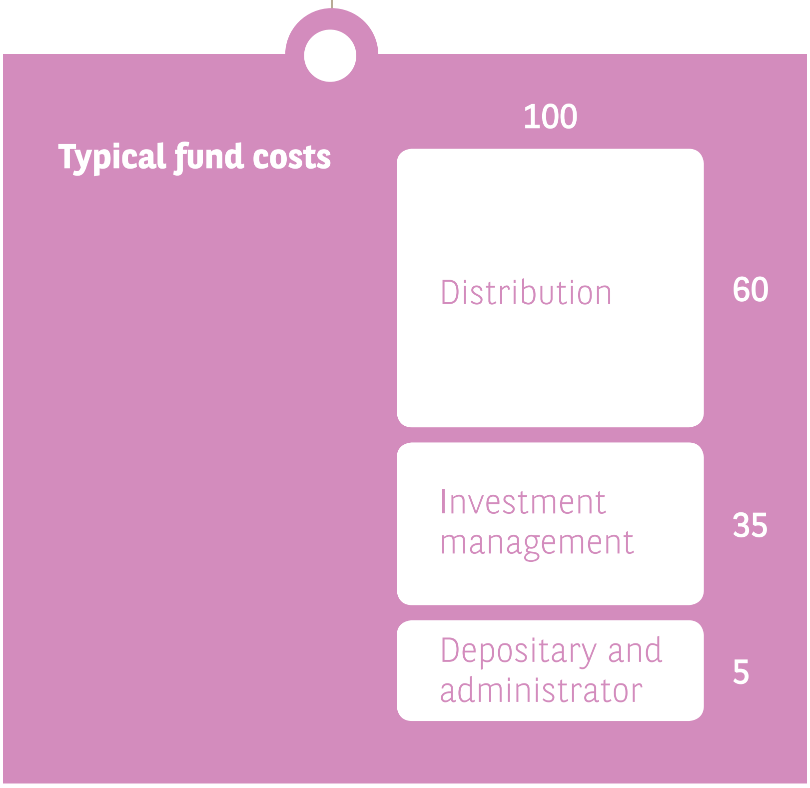
Tomorrow: with UCITS IV
(example set-up)



Variable costs

The main variable cost for an asset manager is that of distribution, which needs close measuring, monitoring and management, in terms of fund creation, maintenance and expansion.

Again, a service provider offering distribution-monitoring on a pan-European basis will allow asset managers to streamline their organisation and save costs.



Source: BNP Paribas estimates

Other parameters to be considered

Lack of harmonisation

Despite the UCITS IV Directive's implementation measures, there will remain a lack of harmonisation — and consequently large variations — across European countries in terms of:

- Tax reporting
- Regulatory reporting
- Transfer agency services
- Responsibilities in the net asset valuation (NAV) calculation process between asset management company, fund administrator and depositary
- Risk management

This highlights the continuous need for local expertise in these matters. Asset managers will have to find the best model and the right balance: combining local expertise with centralisation of operating centres to maximise economies of scale.

Non-UCITS funds: the consequences of AIFM

The European Commission has issued legislative proposals for alternative investment fund managers (AIFM), which is currently still under intense review at both the Commission and the Council of Ministers. This text intends to cover all EU non-UCITS funds. At the time of publication of this white paper, the AIFM Directive's provisions were not finalised. This section is therefore based on the latest version as of December 2009.

If the asset manager has both UCITS and non-UCITS funds, it can also use a management company passport for the latter. Under the AIFM Directive, there will be an opportunity to use both product and management company passports. Similar to UCITS IV, there will be no obstacles to maximum rationalisation when managing non-UCITS funds.

What is not yet clear (until June 2010) is how this structure may be set up: it is possible that asset management companies may need authorisation for UCITS funds and a separate one for AIFM funds.

There will however be certain organisational constraints on the asset manager, including the following:

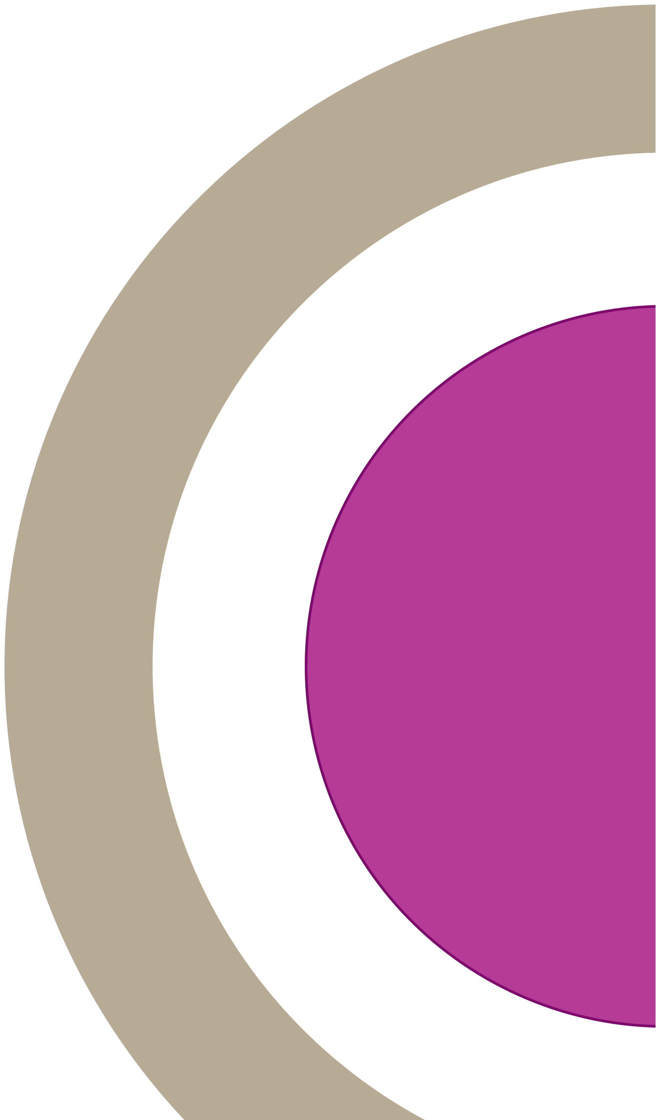
- Risk management
- Fund administration and NAV calculation
- Regulatory reporting
- Outsourcing of asset management functions

There are several differences between the two directives. Under AIFM, a depositary needs to be an EU credit institution, or an investment firm as defined under MIFID, whereas this is not required under UCITS IV.

Similarly, the NAV will need to be performed independently from the asset manager, under the AIFM Directive. This is not required under UCITS IV.

Moreover, there is an issue of definition. The AIFM Directive will cover all non-UCITS funds because the Commission had difficulty in defining a hedge fund, which was their initial target. The one-size-fits-all approach raises important concerns as provisions may not be relevant or adapted to all fund types. These include non-UCITS domestic retail funds, private equity and property (real estate) funds or 'spezialfonds' in Germany.

Therefore assets managers which provide both UCITS and non-UCITS funds will need to comply with the more stringent rules, in other words, those of the AIFM Directive.



Part 4

The role of the depositary

The facts

Depositaries are an essential pillar for investor protection due to the nature of their functions as presented in the Directive: safekeeping of the funds' assets, as well as control of the net asset value of the fund and asset management decisions with respect to the fund's policy. Investor protection is key as it is crucial to restore investor confidence in funds and financial markets as a whole. Investor confidence should be maintained in UCITS IV funds, despite increasingly complex products and the financial turmoil and major frauds of the last two years.

The UCITS IV Directive does not change the definition of the depositary's role from that stipulated in UCITS III. It has two pillars:

Safekeeping

- A common fund or investment company's assets must be entrusted to a depositary for safekeeping

Supervisory functions

- Ensure the sale, issue, repurchase, redemption and cancellation of units are carried out in accordance with the law and the fund's rules
- Ensure the value of units is calculated in accordance with the law and fund's rules
- Carry out the management company's instructions
- Control the investment ratio

Furthermore, no single firm (legal entity) can act as both management company and depositary.

Nothing has changed from UCITS III, except that the depositary has to be in the fund's domicile, regardless of where the asset management company is located. Under UCITS III, the fund, the depositary and the asset management company had to be located in the same country.

However, because of differences in national interpretation, the practical duties and responsibilities vary across EU jurisdictions. In the UCITS Directives, the generic definition of depositary was not supplemented with Level 2 implementation measures. Transposing the directive into national law in each country has therefore provided very different outcomes both on the duties and liabilities of the depositary.

For example, safekeeping is not universally defined. Variations in interpretation of the supervisory role of the depositary with regards to the NAV has led the depositary having to recalculate the NAV in some countries. In others, it is responsible for controlling the NAV process only. In some countries, the depositary has an absolute obligation to return the fund assets in any circumstances including in the case of sub-custody default, whereas in most countries it can discharge itself if it has properly performed due diligence on its providers. In January 2010, CESR published its mapping, highlighting the many differences across the 27 EU Member States.

The European debate

Before the Madoff fraud, the regulatory authorities did not consider the depositary's role to be an issue and therefore resisted changing the definition. This is why its role is simply copied from UCITS III. The Madoff affair and the Lehman Brothers bankruptcy, although two very different events, have highlighted that the level of protection varied from country to country, depending on the national legislation on depositary liabilities. This is a state of affairs which is contradictory to the EU single market, and the principle of the fund passport.

Since 2009, there has been strong political pressure to address this issue of inconsistency. There are now three work streams considering it:

- EU Commission's consultation on depositaries for UCITS (which might lead to a possible UCITS V)
- UCITS IV Level 2 measures, relating specifically to a foreign-based asset manager and the management company passport
- AIFM Directive

The authorities have acknowledged that there were diverging interpretations, resulting in some UCITS investors being better protected than others. The EU's Directorate-General for the Internal Market announced a consultation in June 2009 to look into inconsistencies relating to depositaries' liability in the application of the Directive.

In November 2009, the European Commission published the results of its consultation. It is now in the process of further analysing some issues highlighted by the industry and performing an impact assessment. The outcome of this work is expected in the second half of 2010.

At the same time, the Commission has made stringent proposals on depositaries' regulation, liability, eligibility and so on, in the proposal for the Alternative Investment Fund Managers (AIFM) Directive. Under this proposal, depositaries should be credit institutions based, and supervised, in the EU. Their liability has been strengthened, in particular with regards to assets under custody, including an inversion of the burden of proof. There are clear provisions on due diligence requirements relating to any delegation. The proposed AIFM Directive, including the depositary issue, is still under intense debate at both the Council and the European Parliament. In any case, the provisions that will be adopted will certainly be used as a benchmark for UCITS funds and future UCITS directives.

BNP Paribas believes there is a need for:

- **Clarification and definition of depositary duties**
  Responsibilities and liabilities must be defined for depositaries to know what they have to do

- **Recognition of the practical limits of depositary duties**, in particular on safekeeping. Some elements are indeed beyond the control of the depositary, for example the legal framework in a given country which does not recognise segregation of third-party assets

- **A level of liability that is economically proportionate**
  The depositary is an important pillar of investor protection. Through its various controls over the fund assets, the fund and asset manager processes, it provides significant comfort to the investors and prevents misbehaviour. However, the depositary does not provide a 100% insurance policy, as this would be too costly for the investors and the industry as a whole

- **Harmonisation of duties and liabilities at EU level (both Levels 1 and 2)**
  Harmonisation is an absolute requirement for the promotion of the single market, to ensure the same level of investor protection, regardless of where the EU fund is domiciled

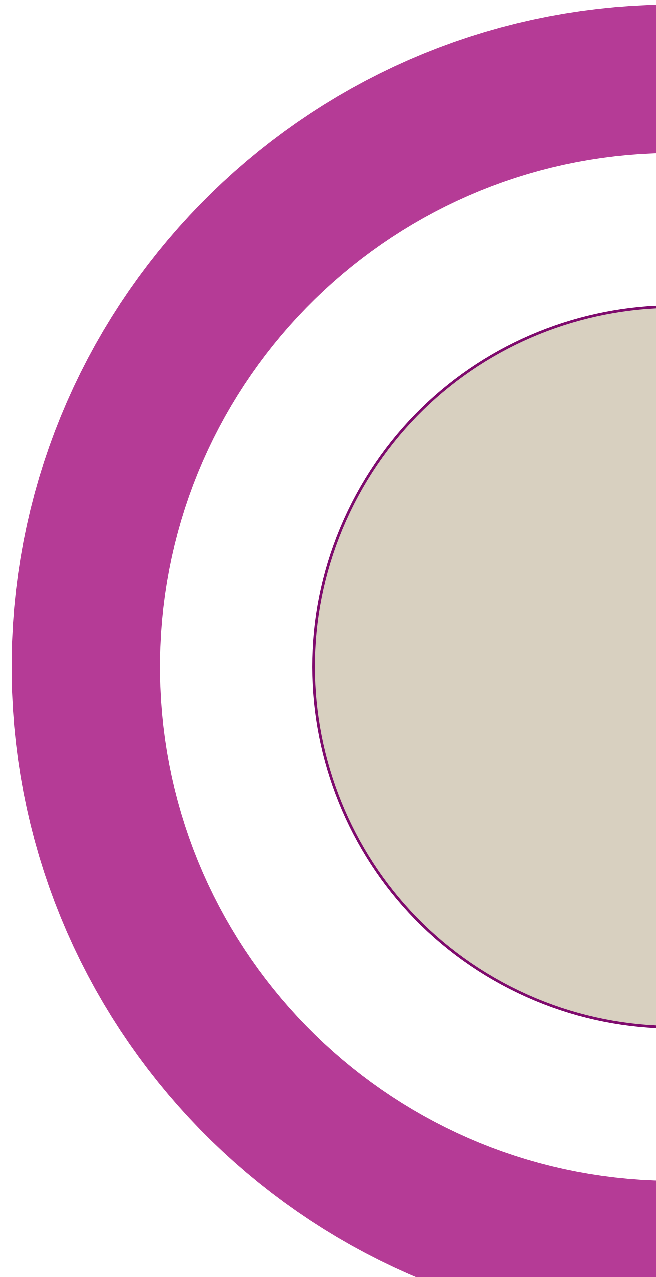
- **A coordinated approach between UCITS consultation and AIFM negotiation, to ensure consistency**

Greater responsibility for the depositary

Against this background, it is of great importance to ensure that depositaries are in a position to perform their duties and responsibilities properly. They will need to combine adequate expertise, operational means and financial strength. The level of risk depositaries will have to assume should be reflected in the depositaries' remuneration. In other words, costs may increase as a result of the greater responsibility imposed on a depositary.

More generally, after the legislation on depositaries is finalised, whether under the AIFM Directive or in another form, the depositary will have to review in detail its obligation, level of liability and business model. The new rules may lead to reinforced depositary controls and new pricing policies. They may also lead to a stricter selection of clients and services, as a depositary may decide no longer to support certain types of assets that are considered too risky.

If legislation imposes very high liabilities on depositaries, we may also see small players exiting the business. Only strong financial entities with solid expertise in this domain, which also enjoy strict control over their sub-custodian network, will be able to offer depositary services.



Conclusions

The UCITS IV Directive should lead to a more efficient and competitive European Union asset management industry.

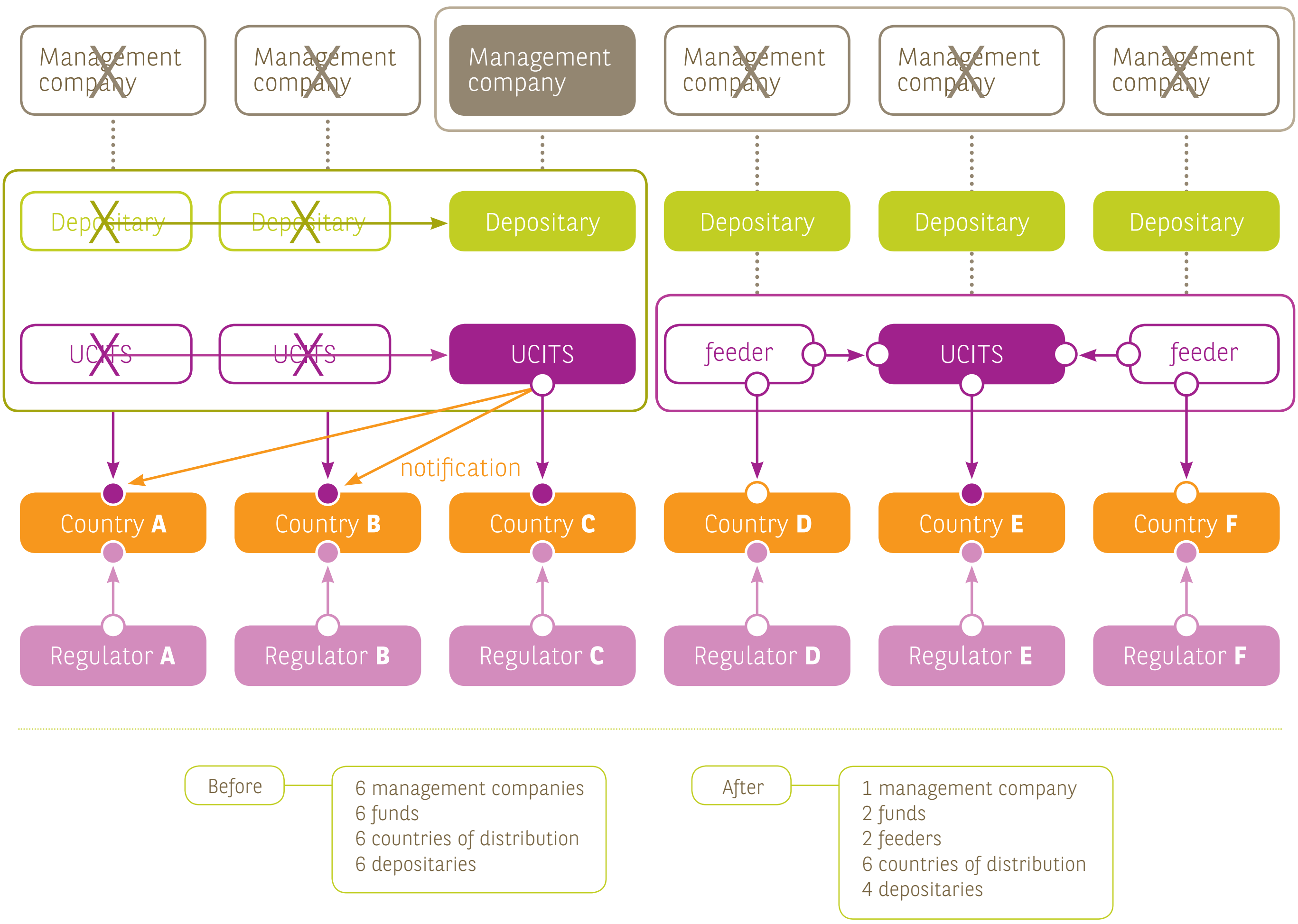
The Directive will most likely result in a shift from the current situation of asset management companies being organised in vertical silos to one where the set-up is more pan-European, centralised and horizontal. Today, an asset manager which distributes in six countries, needs to have six management companies, handle six funds, and use six depositaries. Under UCITS IV, the same asset manager can choose to have only a single management company, two funds, two feeder funds, and use four depositaries, for the same distribution coverage.

Opportunities for asset managers will differ from country to country, and by asset manager business model and size. Options will open up across the various markets depending on the local culture and tax system. The trick for the asset managers is to approach each country bearing in mind their investors' needs and the characteristics of their own organisations. By the same token, local expertise in an asset-servicing provider will continue to be desirable as accounting rules, tax treatment and regulatory reporting will remain country-specific.

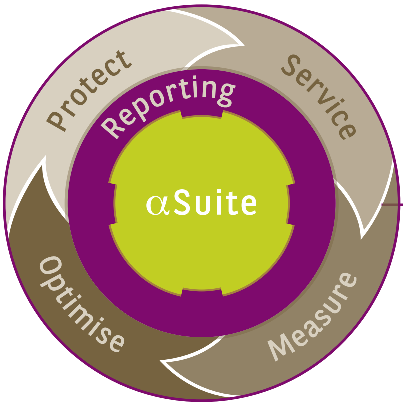
In order to take advantage of UCITS IV, asset managers will need a strategic approach. Those dealing with UCITS and non-UCITS funds also have to consider similarities and differences between the AIFM and UCITS Directives. This will allow regulatory arbitrage. Asset managers will need to decide on the types of investors and markets to target, first within and then outside the European Union.

These issues highlight the need to use a pan-European asset-servicing supplier which has a deep understanding of local conditions, language and culture, connectivity with infrastructures and the trust of the local authorities. Local knowledge can not be underestimated. Moreover, having both a global view and local expertise would be desirable for optimal strategy implementation, whether the asset manager is expanding across – or rationalising within – Europe.

UCITS IV tools in action



About
BNP Paribas Securities Services



BNP Paribas Securities Services is a leading global provider of securities services to the buy side, sell side and issuer segment. It is Europe's number one custodian bank.

Institutional investors (asset managers and owners, distributors and fund sponsors) have access to an array of integrated solutions to optimise our clients' strategy around the world. We have developed the AlphaSuite solution for asset managers, a four-pillared offer that is designed to protect investments, service assets, measure performance and optimise strategy.

We have dedicated teams of UCITS IV specialists in each of our key European locations. They work hand in hand with our public affairs department to help asset managers analyse and optimise their service set-ups, to take advantage of the UCITS IV Directive's opportunities.

Helping asset managers take advantage of UCITS' opportunities

BNP Paribas Service offer

UCITS tools	Cross-border mergers	Master-feeder structures	Management company passport
Fund administration	●	●	●
Depositary	●	●	●
Custody services	●	●	●
Transfer agent	●	●	●
Fund distribution services	●	●	●

Our thought-leadership approach is built on participating in regulatory authority, supranational body and industry association task forces, committees and advisory groups across all of our locations. We are active drivers of the regulatory framework, participating in and influencing the decision-making processes. We are therefore able to interpret the implications of market changes and work with our clients to maximise opportunities and minimise costs and risks.

The following is a selection of bodies we are actively involved with:

International associations

- International Securities Services Association (ISSA)
- Society for Worldwide Interbank Financial Telecommunication (SWIFT)
- European Banking Federation (EBF)
- Association of financial markets in Europe (AFME)
- European Fund and Asset Management Association (Efama)
- Institute of International Bankers (IIB)
- European Trustee and Depositary Forum (ETDF)

Supragovernmental bodies

- European Commission: MiFID, Code of Conduct, UCITS IV
- European Central Bank: TARGET2, TARGET2-Securities, Cogesi
- Committee of European Securities Regulators

The BNP Paribas Group is one of the few banks in the world with a AA Standard & Poor's rating. Other credit ratings are similarly high: Moody's Aa2 and Fitch's AA. The Group is one of the six strongest banks in the world, according to Standard and Poor's. The Group is present in 85 countries, with approximately 202,000 employees, including 159,800 in Europe, 15,000 in North America and 10,100 in Asia (31 December 2009). It holds key positions in Investment Solutions, Corporate and Investment Banking, and Retail Banking.

Glossary

AIFM	Alternative Investment Fund Managers, a European Commission directive for non-UCITS funds
CESR	Committee of European Securities Regulators
CSD	Central securities depositary
Depositary	A company charged with the register and control of a fund's statutory and legal regulations. In general, it may also, but not necessarily, provide custodian services. UCITS IV, however, stipulates the use of a depositary for safekeeping (custody). A depositary can also be called a depositary bank or depo bank.
EFAMA	European Fund and Asset Management Association
EU	European Union of 27 countries or Member States
EUR	euros
FCP	Fonds commun de placement. A fund created by an asset management company, without a company structure.
IMEG	The Investment Management and Expert Group, charged with discussing and developing the technical advice of the implementation (Level 2) measures. A part of the CESR.
KID	Key investor document
KII	Key investor information
Member State	A country member of the European Union (EU)
MiFID	Markets in Financial Instruments Directive
NAV	Net asset value
PEA	Plan d'Epargne en Actions
SICAV	Société d'Investissement a Capital Variable. An open-ended collective investment scheme/fund with a company legal structure.
Transferable securities	Shares in companies or their equivalent, bonds and other forms of securitised debt, any other negotiable securities which can be acquired by subscription or exchange.
UCITS	Undertakings for the collective investment in transferable securities. A public limited company that coordinates the management and distribution of funds (unit trusts, common funds and SICAVs) among European Union Member States, provided the fund and fund managers are registered within the domestic state.
USD	US dollars

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UCITS IV

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for European asset managers
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