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UCITS IV
How to adopt master-feeder structures?

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As from the 1 July 2011, UCITS will be authorised to adopt master-feeder strategies in view of pooling their assets and achieving economies of scales. Why would one consider a master-feeder strategy and what are the main business implications?

Background

Investment strategy allowing rationalisation, economies of scales and new business opportunities.

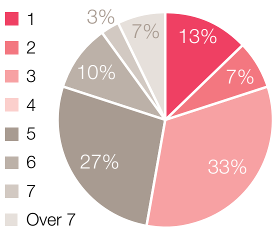
It is well known that the average Assets under Management (AuM) of the European UCITS is too small. Consequently, UCITS ranges must be rationalised to achieve economies of scales and decrease existing Total Expense Ratios ('TER').

For that purpose, UCITS IV introduces, on top of the facilitation of UCITS mergers, another framework for amalgamating assets, by allowing master-feeder structures. As from July 2011, promoters of UCITS will indeed have the possibility to 'pool' their sub-funds under management across the EU.

Combined with the management company passport, master-feeder structures could lead to operational rationalisations and cost savings similar to mergers of UCITS, with fewer (tax) uncertainties.

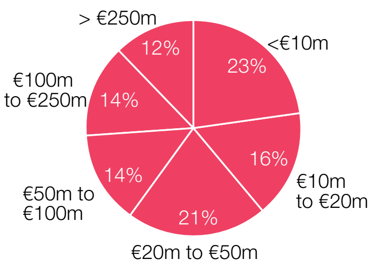
A master-feeder structure could also be a noteworthy option when a promoter believes, for strategic and marketing reasons, that it is preferable to duplicate an existing on-shore UCITS in some of the countries of investors rather than distributing the on-shore UCITS on a cross-border basis.

Number of UCITS domiciles per Group



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

Size of European UCITS



Source Lipper – Figures as at end 2009 based on a sample of 19,735 portfolios

Scope of the UCITS IV master-feeder structures

A feeder UCITS investing in a master UCITS

Any UCITS (contractual or corporate) or an investment compartment thereof will be permitted to adopt a master-feeder investment policy.

However, master-feeder structures are only allowed between European-domiciled coordinated UCITS, meaning that both the feeder and the master must be subject to the European UCITS IV Directive.

However, the Feeder will, by law, derogate from the usual UCITS diversification limits in order to be allowed to invest its assets in only one target UCITS.

Types of authorised investors

In a master-feeder structure, the feeder will be the 'collection fund' in the target distribution country in which retail and/or institutional investors may be allowed to invest.

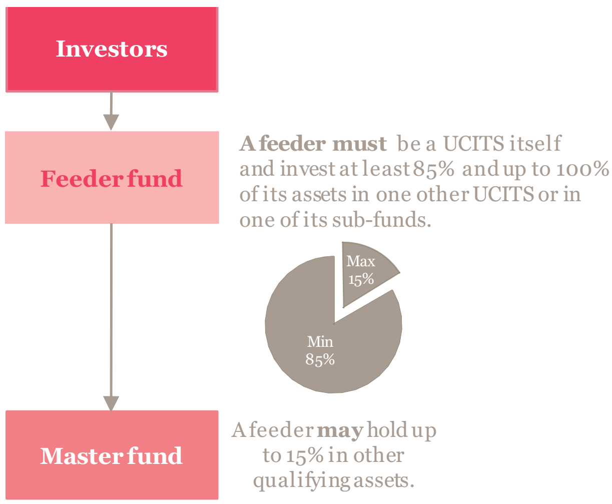
The feeder will then invest the cash received from its own investors in the master, becoming its unitholder and acting in its own name.

At the level of the master, besides the feeder's investment, other investors could obviously be present: institutional or retail investors, other funds of funds and even other feeders.

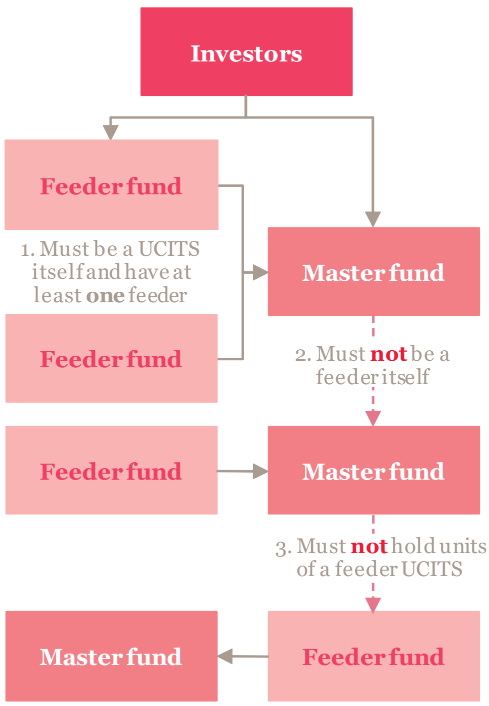
Core requirements of UCITS IV

Investment restrictions

- The feeder will have to invest at least 85% of its assets in the master UCITS with the 15% remaining assets being invested in ancillary liquid assets, derivatives for hedging purposes and movable and immovable property essential for the direct pursuit of the business (for investment companies only).



- The master will be subject to the classic diversification limits as set forth in the UCITS Directive.
- To avoid the creation of opaque structures, the master will, however, not be allowed to invest in another feeder or be itself a feeder.



Competent regulators

- The master-feeder structure will be subject to the authorisation of the feeder's home regulator.
- If the feeder and the master are domiciled in two different jurisdictions, the home regulator of the master is solely involved to confirm officially in writing that the master complies with the investment restrictions (the 'Master UCITS Regulator's Attestation').

Approval of master-feeder structures

- For its creation, a feeder fund will have to provide its home regulator with a set of documents, including its own prospectus and Key Investor Information Document, but also information related to the master (prospectus, Key Investor Information Document, the Master UCITS Regulator's Attestation (where applicable), the information sharing agreements put in place between master and feeder, and also between their respective auditors and depositaries).
- All documents must be transmitted to the home regulator of the feeder in one of the official languages or in the approved language of the feeder home state.
- Approval should be granted within 15 working days following the submission of a complete file.
- In the case of conversion of an existing UCITS into a feeder, the same principles apply, on the understanding that the feeder will have to (i) prior inform its existing unitholders who will have the right to request within 30 days the repurchase or conversion of their units without charges other than disinvestment costs and (ii) notify accordingly each regulator of the feeder host member states in case of cross-border distribution.

Monitoring of the Master UCITS

- The feeder will have to monitor the activity of the master. For that purpose, an information sharing agreement between the feeder and the master will be compulsory (except in the case where both master and feeder are managed by the same company) to ensure adequate information flows are in place.
- The depositary of the master will be responsible for immediately informing both its own and the feeder's regulator, the feeder itself, and also the feeder's depositary and management company (if applicable) about any irregularities detected with regard to the master.

Content of marketing information:

- The prospectus of the feeder shall contain:
  - a declaration that the feeder is a feeder of a particular master UCITS and as such permanently invests 85 % or more of its assets in that master;
  - the investment objective and policy, the risk profile and the performances of the feeder and the master, and, if they are not identical, the reasons why and to what extent they differ, including a description of investments made in the feeder's 15% pocket (if any);
  - a brief description of the master (organisation, investment objective and policy, risk profile, how the prospectus of the master may be obtained, etc);
  - a summary of the information sharing agreement established between the feeder and the master;
  - how the unitholders may obtain further information on the master and the information sharing agreement between feeder and master;
  - a description of all charges payable by the feeder by virtue of its investment in the master and aggregate charges of the feeder and master;
  - a description of the tax implications of the investment into the master for the feeder.
- The Key Investor Information Document of the feeder shall describe:
  - the proportion of the feeder's assets invested in the master;
  - the master's objectives and investment policy;
  - the investment returns of the feeder and master and explanations related to potential differences;
  - the potential differences between the synthetic risk and reward indicator (SRRI) of the feeder and the SRRI of the master;
  - the combination of costs of both in the ongoing charge figure.
- A statement on the aggregate charges of the feeder and the master must be included in the annual report of the feeder as well as how the annual and the half-yearly report of the master can be obtained (also in the semi-annual report).

Main business implications for the UCITS industry

- Promoters of UCITS have to take decisions even though rules are not yet available and master-feeder structures do not even exist in some EU countries for the time being;
- Information flows and monitoring requirements are quite onerous in particular for master-feeder structures using service providers not belonging to the same group;
- New value chain and related fee arrangements would probably need to be put in place, implying management decisions but also regulatory, tax, operational and marketing analyses;
- Potential accounting, central administration and Key Investor Information Document production issues should not be underestimated, in particular in case of cross-border master-feeder structure;
- The potential tax impact and regulatory reporting requirements must be closely analysed before any restructuring decision is made. Indeed, adopting a master-feeder structure may have significant tax implications (i) for investors in their country of residence and (ii) for the UCITS in terms of reporting (Austria, Germany,..) and Savings Directive and may even have some tax impacts in underlying assets' countries. Therefore, the locations of the UCITS should be analysed in depth from a UCITS taxation perspective and access to double tax treaties (DTTs), from an investor's taxation perspective and from a VAT perspective (where the scope of the VAT exemption and input VAT are the most favourable), so as to operate an optimal tax set up. Finally, the location of the management company(ies) of the master-feeder structure must also be taken into consideration.
- Fund promoters will lastly have to make sure that the savings envisaged by a master-feeder structure will exceed the costs incurred.

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