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From UCITS Directive to UCITS III Provisions

On 20 December 1985, the European Parliament approved Directive 85/611/EEC with the aim of creating a level playing field for the Member States in relation to marketing and management of UCITS (Undertakings for Collective Investment in Transferable Securities) – a class of investment products that includes mutual funds and SICAVs (*société d'investissement à capital variable*, or investment companies with variable capital).

The introduction of this directive, also known as UCITS I, provided a fundamental change: it provided the right, for funds authorized by a Member State, to obtain a so-called European Passport and therefore sell their shares or units also in other European countries.

Although many UCITS I provisions were already entailed in the legal framework of some Member States, the introduction of the passport was considered as the first step towards greater harmonization of the market. According to previous legislation, in fact, no funds could be distributed within the EU without obtaining the necessary permission in each country separately.

On 21 January 2002, two new directives were published with the name UCITS III[1] (2001/107/EC, or "Management Company Directive" and 2001/108/EC, or "Product Directive"). While the UCITS I directive granted the European passport only to those UCIs[2] investing in transferable securities like stocks and bonds, UCITS III extended

[1] The second version of the UCITS directive, or UCITS II, contained a number of proposals considered too complex and ambitious and was then abandoned by the European Council of Ministers.

[2] Undertakings for Collective Investments.

this opportunity also to UCIs investing in a much broader range of products, allowing them to increase the set of available strategies.

In the next three sections, we summarize the major innovations introduced by UCITS III and describe the operating model of these new UCITS III-compliant hedge-fund-like products, generally referred to as "Newcits".

1.1 PRODUCT DIRECTIVE

Directive 2001/108/EC, or Product Directive, allows a greater number of UCITS to qualify for the status of "harmonized product" and defines the constraints to be respected in the allocation of assets by the investment vehicle. In addition to securities like stocks and bonds, the directive allows UCITS to make extensive use of derivatives and use them not only with a hedging purpose, but also as a way to achieve higher returns and implement leverage. The use of money market instruments, bank deposits and investment in the shares of other UCIs is permitted. Moreover, it is possible to reproduce indices, although it is still under discussion whether or not the reproduction of hedge fund indices should be allowed.

Table 1.1 shows the constraints faced by UCITS with regard to investment in each class of instrument.

1.2 MANAGEMENT COMPANY DIRECTIVE

The Management Company Directive introduced a set of rules that allows the asset management company to directly offer the administrative and marketing services of UCITS, in addition to traditional fund management activities. Once authorized in a Member State, in fact, a management company can freely exercise its activities in any other Member State, for example through a subsidiary or a branch.

Although Article 5 of the UCITS III directive gives the management company a passport that allows it to exercise in the territory of any Member State for which the activity was authorized, no management company may engage in activities that are different from

Table 1.1 Investment possibilities under UCITS III directive

Asset	Constraints
Money Market Instruments [*Arts. 19(1)A, B, C, H; 22(1), (2)*]	• They are admitted to or dealt in on a regulated market. • They are not traded on a regulated market, but they are issued or guaranteed by a central, regional or local institutions such as central banks, by third countries, by recognized institutions, or by enterprises whose securities are traded on regulated market. • It is not possible for a UCITS to invest more than 5% of its assets in instruments that are issued by a single issuer. Member States may raise the limit up to 10%. However, the total amount of the instruments for which the 5% limit is exceeded cannot represent more than 40% of its assets.
Units of Other Investment Funds [*Arts. 19(1)E; 24; 25(2)*]	• The underlying investment fund has not invested more than 10% of its assets in units of another investment fund. The investment in non-UCITS funds must not exceed 30% of the portfolio. • The level of protection for investors of such funds and the level of supervision on those funds must be equivalent to that established by legislation. The investment in another fund may not exceed 25% of that fund's units.
Deposits with Credit Institutions [*Arts. 19(1)F; 22(1)*]	• They must be repayable on demand or they can be withdrawn. • They are maturing in no more than 12 months. • Less that 20% of the UCITS' assets are held by a same credit institution.

(*continued*)

Table 1.1 Investment possibilities under UCITS III directive (*Continued*)

Asset	Constraints
Financial Derivatives [*Arts. 19(1); 21; 22(1)*]	• The underlying assets consist of instruments covered by the directive, indices, interest rates, exchange rates or currencies, provided that the investment is consistent with the objectives outlined in the fund rules. • The global exposure relating to derivative instruments shall be less than UCITS' NAV. • This exposure is calculated in relation to the current value of the underlying assets, counterparty risk, future market movements and time available to liquidate positions. In the case of OTC derivatives: • Counterparties must be institutions subject to prudential supervision and they must be approved by the competent authorities for UCITS. • Derivatives must be subject to a reliable and verifiable valuation on a daily basis. • They can be sold, liquidated or closed by an offsetting transaction at any time, at their fair value. • Exposure to a single counterparty is less than 5% of UCITS' assets (10% if the counterparty is a bank or a credit institution).
Index-Tracking Funds [*Art. 22a*]	• Less than 20% of the UCITS' assets must be invested in a single issuer (Member States may allow an upper limit of 35% if, according to the objectives of the fund, the goal is the reproduction of an index approved by the competent authorities). • The index must be sufficiently diversified, it must represent an appropriate benchmark and it must be published.

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the management of UCITS, unless it is not the additional management of other UCIs not covered by the directive and on which the management company is subject to prudential supervision.

In addition to the management of mutual funds and investment companies, Member States may authorize management companies to provide the following services:

- Management of investment portfolios, including those owned by pension funds. This must happen in accordance with the mandate that was given by investors, if such portfolios include one or more of the securities listed in Section B of ISD (93/22/EEC).
- Advice on investments in securities listed in Section B of ISD (93/22/EEC)

In any case, the authorization of the management company is always subject to the conditions shown in Tables 1.2 and 1.3.

If the type of UCITS provides for the presence of an investment company, this company is subject to the conditions reported in Tables 1.4 and 1.5.

1.2.1 Simplified Prospectus

The Management Company Directive also established, alongside the full version of the prospectus already provided by UCITS I, the publication of a simplified prospectus, in order to make the marketing of products more investor friendly and accessible.

The first part of the simplified prospectus must contain a brief presentation of the UCITS, with information on the date of establishment of the mutual fund or investment company and an indication of the Member State in which the mutual fund or investment company was set up. Also, the following information must be contained in the prospectus:

- Number and type of investment compartments contained in the UCITS;
- Name of the management company, if any;

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Table 1.2 Management company: conditions for taking up business

Minimum Capital Requirements [*Art. 5a (1)A*]	• The management company has an initial capital of at least EUR 125,000. • When the value of the portfolios of the management company exceeds EUR 250 million, the management company shall be required to provide an additional amount of own funds. This additional amount of own funds shall be equal to 0.02% of the amount by which the value of the portfolios of the management company exceeds EUR 250 million. The required total of the initial capital and the additional amount shall not, however, exceed EUR 10 million. • Irrespective of the amount of these requirements, the own funds of the management company shall never be less than the amount prescribed in Annex IV of Directive 93/6/EEC. • Member States may authorize management companies not to provide up to 50% of the additional amount of own funds referred to in the first point if they benefit from a guarantee of the same amount given by a credit institution or an insurance undertaking. The credit institution or insurance undertaking must have its registered office in a Member State, or in a non-Member State provided that it is subject to prudential rules considered by the competent authorities as equivalent to those laid down in Community law.

(*continued*)

Table 1.2 Management company: conditions for taking up business (*Continued*)

Location of Head Office and Registered Office *Art. 5a (1)D*]	• Both its head office and its registered office are located in the same Member State.
Directors of Managent Company [*Art. 5a (1)B*]	• They shall possess a good reputation and sufficient experience in relation to the type of UCITS managed by the management company.

Table 1.3 Management company: operating conditions

Organization [*Art. 5f (1)A*]	• The management company must have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control procedures.
Conflict of Interests [*Art. 5f (2)*]	• The management company shall not be permitted to invest all or a part of the investor's portfolio in units of unit trusts/common funds or of investment companies it manages, unless it receives prior general approval from the client.
Delegation of Own Functions to Third Parties [*Art. 5g(1) A, E, I, (2)*]	• Member States may allow management companies to delegate the exercise on behalf of one or more of their functions provided that the competent authorities are informed. • A mandate with regard to the core function of investment management shall not be given to the depositary or to any other undertaking whose interests may conflict with those of the management company or the unit holders. • The UCITS' prospectuses list the functions that the management company has been permitted to delegate.

Table 1.4 Investment company: conditions for taking up business

Minimum Capital Requirements [*Art. 13a (1)*]	• If the investment company has not designated a management company (i.e. it is "self-managed", the initial capital must be at least EUR 300,000.
Legal Form [*Art. 12*]	• The Member States shall determine the legal form that an investment company must take.
Directors of Management Company [*Art. 13a (1)*]	• They must meet the requirements of a good reputation and they must be sufficiently experienced in relation to the type of business carried out by the investment company.

- Expiration date of the UCITS, if any;
- Custodian bank;
- Auditors;
- Promoters of the UCITS.

The second part of the simplified prospectus provides investment information, indicating the objectives and policies of the investment company or investment fund, as well as a brief assessment of risk profiles. In this section it is also required to present the historical

Table 1.5 Investment company: operating conditions

Organization [*Art. 13c*]	• An investment company must have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control procedures.
Management on Behalf of Third Parties [*Art. 13b*]	• Investment companies may only manage the activities of their portfolios and cannot, in any circumstances, receive any mandate to manage assets on behalf of third parties.

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performance of the mutual fund or investment company (with the caveat that this is not an indicator of future performance) and the profile of the typical investor for whom the fund or the investment company is designed.

The third part contains information about taxation, entry and exit fees and any other costs, distinguishing between those charged directly to unit holders and those to be charged to the fund or investment company.

The following section includes commercial information, such as how to purchase and sell shares, how to move from one compartment to another with the amount of fees to be paid (when the UCITS is split into several compartments), the date of distribution of dividends, as well as the timing, place and way in which prices are published.

Finally, the investor should be informed about the opportunity to get, at no cost and at any time, a copy of the full prospectus. This last section must also indicate the competent authority, the contacts from whom to receive more information and the date of publication of the prospectus.

1.3 ADDITIONAL REGULATORY LIMITS IMPOSED BY UCITS III

1.3.1 The Prohibition on Borrowing and Short Selling

In addition to the general requirements and limitations that apply to a UCITS, there is the prohibition on borrowing as a means to implement leverage. Article 36 of the UCITS III directive, in fact, clearly states that neither the investment company nor the custodian bank (on behalf of mutual funds) are authorized to borrow money, with the exception of the purchase of foreign currencies by means of "back-to-back"[3] loans. Notwithstanding this prohibition, provided that the loans are just temporary, Member States may authorize UCITS to

[3] "Back-to-back" are loans where two companies that are located in different countries lend each other a certain amount of money in their respective currencies (at spot exchange rate) and then return it to one another at maturity.

borrow an amount that is equal to 10% of their assets (in the case of an investment company) or 10% of the value of the fund.

Investment companies can also borrow up to 10% of their assets if these loans are aimed at the purchase of immovable property (i.e. buildings, offices, etc.) that is essential for the direct pursuit of its business. In any case, the amount of these loans, together with temporary loans, may not exceed 15% of their assets, if summed to the temporary ones.

Even if repurchase agreements (or repos) are not permitted, the fund may still leverage up to a maximum of 200% of NAV using derivatives such as futures, swaps or CFDs.

Finally, Article 42 states that neither the investment company, nor the management company, nor the depositary (on behalf of mutual fund) may carry out uncovered sales of transferable securities, money market instruments or other financial instruments referred to in Article 19(1)(e), (g) and (h).

Later in this book, we will present the main strategies adopted by Newcits fund managers and will show how it is possible to overcome these limitations by taking synthetic positions using so-called Contracts for Difference, or CFDs.

1.3.2 Prohibition on Investment in Commodities

Directive 85/611/EEC [Art. 19(2)d] specifies that a UCITS may not acquire precious metals or certificates representing them. In general, the use of commodity derivatives is also not permitted, even though on this point there are still different interpretations of the directive in relation to their eligibility.

However, the prevailing interpretation is that the use of structured products, even when the underlying instruments are not allowed by the UCITS III provisions (oil and other raw materials, for instance) is allowed, provided that these products qualify as "transferable" (i.e. they are sufficiently liquid, marketable and market prices are always available and reliable).

CESR considers that indices based on financial derivatives on commodities are eligible.

1.4 THE NEXT STEP: UCITS IV DIRECTIVE AND NEW PROVISIONS BY EU

On 13 January 2009, the European Parliament approved Directive 2009/65, or UCITS IV, which reforms various aspects of Community law in relation to UCITS. Member States are expected to adopt this set of provisions starting from 1 July 2011. One of the most important aspects of the directive is the introduction of a "management passport" that will make it possible for an investment company to be managed by a management company established in another Member State, if certain requirements are met.

With this new definition of passport, a manager who wishes to replicate one of his products in another Member State would no longer need to create a replica of the fund, but could sell the same product abroad, with the only requirement that the custodian bank is placed in the host country. In this case, the directive provides that the management company is subject to the supervision of the Member State of origin, while the investment company should observe the rules of the Member State in which the UCITS is managed.

Another major innovation is the harmonization of procedures for cross-border mergers of funds, which reduces the administrative burden on management companies.

The directive introduces new rules on master–feeder structures, which allow a UCITS called a "feeder" to invest all or part of its assets in another UCITS called a "master". This provision is expected to foster the development of new business opportunities and to increase the efficiency of investment policies.

Finally, the provisions of UCITS IV will have a significant effect on the delivery of information to investors. The simplified prospectus will be replaced by a so-called "Key Investor Information" (KII), or more probably from a "Key Investor Document"[4] (KID), which is a simple statement of one page that contains information that is essential to assess the investment in the UCITS. The aim of the KID

[4] This terminology is considered most appropriate as it emphasizes the need to create a document that has a standardized format for all UCITS and makes comparison between products easier.

is also to compare different investment opportunities more easily, especially in terms of costs and risk profile.

While these provisions have been welcomed by most of the states involved, Luxembourg and Ireland (where the majority of UCITSs are managed) have shown several doubts. The two countries, fearing to lose their hegemony as Member States of origin, said they were reluctant to maintain vigilance on funds that are domiciled elsewhere and do not have any actual presence in the nation. Another concern of the authorities of both countries is the lack of control over accounting and pricing.

However, the introduction of the European passport would avoid the creation of clones and pave the way for cross-border mergers, while the increase in assets under management would create economies of scale and reduce both organizational and management costs. According to some estimates,[5] in Europe, there are over 36 000 funds, compared to the 8000 US funds; in both cases, assets under management are about 5 trillion dollars in total. It is clear that UCITS IV is therefore an important opportunity to increase organizational efficiency and rationalize procedures. Cross-border mergers will not necessarily lead to the loss of supremacy and supervision of Dublin or Luxembourg. If mergers will allow funds to be raised from different sources in a single structure, in fact, companies will be more inclined to choose well-functioning international jurisdictions in which to establish their funds, like Ireland or Luxembourg. Thus, the two countries could still maintain their leading position as States of origin of funds through the supervision of the management company.

In summary, the main innovations introduced in the UCITS IV directive are the following:

- simplification of the notification procedure;
- replacement of the simplified prospectus with the *Key Investor Document* (KID);

[5] *Ignites*, the online magazine of Financial Times

- management company passport;
- master–feeder structures;
- mergers between UCITSs.

1.5 SIMPLIFICATION OF THE NOTIFICATION PROCEDURE

UCITS III provides previous notification to the competent authority of the host country, followed by continuous interaction with the same authority during all the subsequent stages. Before the fund may be marketed, it is also necessary to have a waiting period of 2 months and a translation of all the required documents.

Several measures have already been adopted in order to simplify and speed up this process. For example, in June 2006, CESR had published guidelines on simplification of the notification procedure of foreign harmonized UCITSs, while, the following year, the European Commission had announced some details regarding the powers of the Member State of origin and host Member States in the marketing of UCITSs.

The UCITS IV directive will provide interaction between the competent authorities of the country of origin and the host country, only requiring that the KID is translated into the language of the host country. The waiting period will also drop from 2 months to 10 days and the competent authority of the host country will carry out ex-post controls.

1.6 REPLACEMENT OF THE SIMPLIFIED PROSPECTUS WITH THE KEY INVESTOR DOCUMENT

The simplified prospectus provided by UCITS III has the function of presenting basic information about the UCITS that is subject to underwriting, in order to give the investor the possibility to make an aware decision. However, so far, this document does not seem to have achieved its goals, as it was probably considered too long and

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complex by the average investor, as well as inappropriate to allow easy comparison between different UCITS.

For this reason, the new document provided by the UCITS IV should only contain:

- a brief description of the objectives and the investment policy of the UCITS;
- the presentation of past performance;
- fees and costs connected with the investment;
- the risk/return profile of the investment, including appropriate guidelines and warnings about the other possible risks.

This information shall be written in a concise and non-technical language.

In the document published on 8 July 2009, CESR gave its opinion on the complete and detailed content of KID, also providing:

- specific requirements in the case of umbrella (or multi-compartment) UCITS, funds of funds, master-feeder structures, structured UCITS, UCITS with capital protected, etc.;
- specific details of format and presentation of the KID;
- specific conditions for the provision of key investor information.

The main consequences of this legislation include:

- regulation for issuers: a new simplified prospectus scheme has entered into force that anticipates some form and content of the KID;
- how to communicate so-called "local information" (i.e. information on how to buy or sell): the use of signposting (the publication on a website) was preferred over direct inclusion in the KID, in order to make the document easier to read.

1.7 MANAGEMENT COMPANY PASSPORT

The management passport granted by UCITS III is just "partial", as it allows both asset management on behalf of third parties and distribution of funds but it still does not permit to establish mutual funds in Member States other than their country of origin.

By contrast, UCITS IV will recognize this possibility, thus abandoning the principle of the UCITS home Member State uniqueness, which currently requires that the manager, the product and the custodian bank be placed in the same country.

However, the custodian bank will have to be located in the UCITS home Member State under the shared supervision and responsibility of the authorities "home" and "host".

In the document published on 8 July 2009, CESR gave its opinion on the following issues:

- organizational requirements and conflicts of interest in the management company;
- rules of conduct and conflict of interest in the management company;
- risk management;
- obligations of the depositary;
- control procedures and investigation by the competent authorities
- procedures for exchange of information between the competent authorities;
- application of the rules of conduct, which are prepared by the State of origin of the branch.

1.8 MASTER–FEEDER STRUCTURES

The limitations imposed by UCITS III prevent a mutual fund to invest its entire capital in one another fund. Consequently, mutual funds are not currently allowed to set up harmonized "master–feeder structures" (where the function of the feeder funds is to raise capital that is then invested in one another fund, called "master").

Under the new UCITS IV rules, a feeder fund will be able to invest at least 85% of its assets in one master fund, while the remaining 15% will be invested in other assets such as cash, securities, or immovable assets.

The following rules are also defined:

- The feeder funds may be established in Member States other than the master fund;
- A master cannot itself be a feeder and cannot invest in a feeder. At least one UCITS feeder fund must be present among the unit-holders of the master.

In the document published on 8 July 2009, CESR gave its opinion in terms of master-feeder structures:

- agreement between master and feeder and rules of conduct (if the master and the feeder are operated by the same company);
- measures to prevent "market timing" (coordination of master and feeder in the calculation of NAV);
- settlement, merger and split of a master;
- agreement between the custodians of the master and the feeder (if different);
- reporting requirements by the depositary of the master;
- agreement between the auditors of the master and the feeder (if different).

The law here seems to present some critical issues that are still unresolved, for instance in relation to:

- Which law is applicable to the agreement between master and feeder: the law of the State of origin of the feeder, of the master, of a third country, or leave the choice to the UCITS;
- the type of irregularities that are believed to have a negative impact on the feeder UCITS;
- the role of the custodian of the feeder and the master.

1.9 MERGERS BETWEEN UCITS

This section of the UCITS IV directive sets the rules for mergers involving two or more UCITS or UCITS compartments.

Since the UCITS involved in the merger may be formed in different forms (contractual, corporate or unit trust), mergers could take place between an investment company and a mutual fund (see Art. 38, subpar.1). The provisions of the directive on mergers that refer to UCITS also include their compartments (Art. 37, subpar. 2).

Although some Member States can only authorize contractual funds, these rules do not require Member States to introduce new legal forms of UCITS, because each Member State will have to allow and recognize cross-border mergers between all types of funds (see Art. 26).

Scope

Mergers falling within the scope of the directive may be (see Art. 38, subpar. 2):

- **Cross-border:** mergers between UCITS (including at least two established in different Member States) or mergers between UCITS established in the same Member State in a newly created UCITS established in another Member State.
- **National:** mergers between UCITS established in the same Member State, where at least one of the involved UCITS has been authorized to the cross-border marketing (in accordance with Art. 93). This means that mergers between UCITS that are established in the same Member State and that did not conduct the notification procedure for cross-border marketing fall outside the scope of the directive (but they are still subject to national rules).

General Principles

The directive refers to the three most common techniques of merger that are used in the Member States:

- Incorporation merger;
- Classical merger;
- Merger following partial transfer.

This does not imply an obligation for all Member States to include all of the three techniques in their national law. However, each

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Member State must approve the transfer of assets developing from these merger techniques (see par.28).

The new directive also does not prevent the use of other merger techniques on a national level when none of the UCITS involved in the merger has been authorized to the cross-border marketing of its units. These mergers are subject to the relevant provisions of national law (see par.28.)

Incorporation Merger

A merger is a financial operation where one or more UCITS transfer all their assets and liabilities to another existing UCITS (recipient) in exchange for the allocation of units of the recipient UCITS (and, if applicable, a cash payment not exceeding 10% of net asset value of such units) to the holders of the merging funds (Art. 37, *letter a). After the merger has become effective, the merging UCITS shall cease to exist.*

Classical Merger

A classical merger is a transaction where two or more UCITS transfer all their assets and liabilities to a new UCITS (recipient) created by them, in exchange for the allocation of units of the recipient UCITS (and, if applicable, a cash payment not exceeding 10% of net asset value of such units) to the holders of the merging funds (Art. 37, letter b). After the merger has become effective, the merging UCITS shall cease to exist.

Merger Following Partial Transfer

A merger with partial transfer is a transaction where one or more merging UCITS transfer all their equity to an existing UCITS or to a new UCITS created by them (recipient).

In this case, the net assets of the merging UCITS shall be transferred to the recipient or, if necessary, to the depositary of the recipient. In addition, the merging UCITS continue to exist until all liabilities have been settled.

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Applicable Law

The techniques used for cross-border mergers should be included under the law of the UCITS home Member State, while domestic mergers falling within the scope of the directive must be included under the existing provisions of the Member State in which the merging UCITS are established.

Authorization Procedure for Merger: General Principles

Mergers falling within the scope of the directive are subject to prior authorization by the authorities of the home Member State of the merging UCITS. When merging UCITS are established in different Member States, the competent authorities of each State must work closely together through an appropriate exchange of information before approving the merger. In addition, also the interests of the unit-holders of the recipient UCITS have to be considered by the authorities of its home state.

Checks Undertaken: Custodians and Auditors

Both custodians of merging and recipient UCITS must carry out a series of controls. They should verify the compliance with the requirements of the directive, with the rules of the fund, with the acts constituting the type of merger, with the type of UCITS involved, with the date of effectiveness of the merger and with the rules that apply to the transfer of assets and exchange of shares.

A custodian or a qualified independent auditor[6] (pursuant to Directive 2006/43/EC) shall prepare a report on behalf of all investment funds affected by the merger in order to explicate:

- the criteria used for evaluation of assets and liabilities at the date on which the merger takes effect;

[6] With the term "independent auditors" are meant the statutory auditor of the merging UCITS and the statutory auditor of the recipient UCITS.

- the payment in cash per share or unit (if any);
- the method adopted for the calculation of the exchange ratio;
- the actual exchange ratio set at the date on which the merger takes effect.

In order to limit the costs associated with cross-border mergers, it should be possible to compile a single report for all UCITS involved.

Information for Unit-Holders of Merging and Recipient UCITS

Both the merging and the recipient UCITS must provide adequate and accurate information on the transaction to their respective participants, so that they can assess the impact of the proposal on their investment.

This information should include:

- the motivation for the merger proposal;
- the possible impact of participants, including any differences in policies, investment strategies, costs, expected returns, reporting and taxation;
  - any specific right that participants have in relation to the merger proposed. This includes the right to obtain additional information, the right to request a copy of the report of the independent auditor or the depositary, the right to require the repurchase or redemption or, if appropriate, the conversion of its units/shares to regulatory requirements;
- the procedural aspects and the date on which the merger becomes effective;
- a copy of essential information (KII) about the recipient UCITS.

This information is provided to participants of the UCITS involved only after the authorities of the State of origin of the merging UCITS have authorized the operation, but at least 30 days before the deadline for the repurchase or redemption or, if appropriate, the conversion of the units/shares.

If the merging or the recipient UCITS has been authorized to the cross-border marketing, such information must be provided in the official language or one of the official languages of the host State, or in a language approved by the respective competent authorities.

Approval of the Merger by the Participants

If the legal framework of a Member State requires the approval by the participants of the UCITS affected by the merger, such approval may not require more than 75% of the votes actually cast by the participants or represented at the general meeting of the participants.

This provision does not affect the quorum prescribed by national law, but where appropriate, Member States shall not impose a quorum that is more stringent than that applicable to domestic mergers. In addition, they may not require a quorum that is more stringent than those contained in the provisions for mergers of corporate entities.

Rights of Participants of Merging and Recipient UCITS

Under Article 45, par.1 of the directive, the participants of both the merging and the recipient UCITS have the right to request at no cost (with the exception of those held by the UCITS for divestiture, as indicated in their prospectuses. See Art. 30):

- the repurchase or redemption of their units/shares;
- where possible, the conversion of their units/shares in units/shares of another UCITS with similar investment policies and managed by the same management company or any other company with which the management company is linked by common management or control or by a substantial direct or indirect participation;

This right shall take effect as soon as all the participants are informed about the merger and it should end five days prior to the date of calculation of the exchange ratio.

Notwithstanding Article 84, par.1 of the Directive (under which a UCITS repurchases or redeems its units at the request of the holder of units/shares), Member States may allow their competent authorities to require or authorize the temporary suspension of the subscription, repurchase or redemption of units/shares, provided that the aim of such suspension is the protection of the participants (see Art. 45, subpar. 2).

Any legal, consulting or administrative fees related to the preparation and completion of the merger cannot be borne by merging or recipient UCITS or by participants. This rule does not apply when the UCITS have not designated a management company (for example in the case of a self-managed SICAV).

1.10 NEW EU DIRECTIVE ON ALTERNATIVE INVESTMENTS

The crisis that hit markets in the second half of 2007 drew attention to several weaknesses in the financial system and called for an overhaul of supervisory arrangements and regulations involving all the major players in European financial markets.

On 30 April 2009, the European Commission published a draft law concerning the alternative investment market that is pushing management companies specialized in hedge funds to rethink their offer by introducing UCITS III-compliant products. If both the European Council (ECOFIN) and the European Parliament will find an agreement on the text of the directive, the new rules are expected to come into force in 2011. But what are the contents of the proposal?

The main objective of this directive is the introduction of a new framework at European level that is effective and "harmonized", in order to allow the regulation of AIFM (Alternative Investment Fund Managers), which include undertakings for collective investment such as hedge funds, private equity funds, real estate funds and commodity funds. The term "alternative" includes all those funds that do not currently classify as "harmonized" under the UCITS directive.

The main objectives of the AIFM directive are the following:

- ensure that all AIF operators comply with the requirements of appropriate licensing and registration;

- provide a framework for better control of so-called "macro-prudential" risk, for example through the sharing of relevant information between supervisors;
- improve risk management and organizational precautions to reduce the micro-prudential risks;
- increase the level of shareholder protection;
- increase the level of transparency for AIF owning controlling stakes in companies;
- develop a single market for alternative investment funds.

Through the application of these principles, the AIFM directive aims to limit some important classes of risk (see Table 1.6), with the purpose to protect not only the interests of investors, but also the interests of other stakeholders such as creditors, counterparts and the entire European financial market.

It has to be noticed that the nature and intensity of these risks may vary substantially depending on the business model pursued by operators. For example, the so-called "macro-prudential risks" associated with the use of leverage mainly concern the activities of hedge fund managers and commodity funds, while the risks associated with the management of the companies included in the portfolio mainly relates to Private Equity funds.

Other risks, such as those related to the management of "micro-prudential risks" (for instance internal risk management systems) and investor protection are common to all types of AIF.

Many of these risks have actually occurred recently and they have been the primary cause of many upheavals in financial markets. For example, the sudden settlement of large leveraged positions by hedge funds in response to tightening credit conditions, as well as investor redemption requests had a significant role in the collapse of the market and considerably reduced the level of liquidity.

Given the global nature of their activities, many of the risks associated with AIF do have an international dimension and their consequences might be felt beyond national borders. This explains the

Table 1.6 Overview of the main risks. *Source:* Commission of European Communities.

	Source of risk
Macro-prudential (systemic) risks, in particular the use of leverage	• Direct exposure of systemically important banks to the AIFM sector • Pro-cyclical impact of herding, risk of concentration in particular market segments and deleveraging on the liquidity and stability of financial markets
Micro-prudential risks	• Weakness in internal risk management systems with respect to market risk, counterparty risks, funding liquidity risks and operational risks
Investor protection	• Inadequate investor disclosures on investment policy, risk management, internal processes • Conflicts of interest and failures in fund governance, in particular with respect to remuneration, valuation and administration
Market efficiency and integrity	• Impact of dynamic trading and short selling techniques on market functioning • Potential for market abuse in connection with certain techniques, for example short-selling
Impact on market for corporate control	• Lack of transparency when building stakes in listed companies (e.g. through use of stock borrowing, contracts for difference), or concerted action in 'activist' strategies
Impact on companies controlled by AIFM	• Potential for misalignment of incentives in management of portfolio companies, in particular in relation to the use of debt financing • Lack of transparency and public scrutiny of companies subject to buy-outs

need to establish uniform criteria to maintain a proper level of market stability.

What are, in detail, the main provisions introduced by the directive, and how are they going to be applied?

First, all AIFMs domiciled in Europe with more than 100 million euro[7] in assets under management will have to be approved by the competent authorities of the Member State and will be obliged to meet a series of requirements.

Second, all AIFMs operating within the European Union will have to prove to be sufficiently qualified to offer their investment services. They will have to provide adequate and detailed information about the planning of their activities, the identity and profile of managers, the governance of the fund, the risk management measures adopted in the custody of their assets and the methods of reporting. The AIFM will also hold a minimum level of cash as collateral.

In reference to the methods of reporting, more stringent requirements will be introduced that will oblige AIFMs to provide periodic information about markets and instruments where the capital is invested, in addition to performance data and risk concentration.

If compliant with these requirements, an AIF authorized by a Member State will be allowed to market its shares or units in another Member State using a simple notification procedure that consists in the transmission of relevant information from one country to another.

In addition to general requirements, there are some provisions that would only concern alternative investment fund managers engaged in specific activities. These provisions take account of differences in business models of operators and they adapt more easily to their risks.

For instance, operators that make extensive use of leverage would be required to provide additional information to investors and they should inform the competent authorities about their actual leverage. Moreover, in case of AIFM buying shares in companies, additional

[7] The threshold is set to 500 million euros in the case of AIFM without leverage and a lock-in provision of at least 5 years.

information requirements would apply when a controlling stake is reached.

Finally, the requirements contained within the proposal as a whole would impose additional administrative burdens to operators, but their size is still uncertain and in any case, they would mainly depend on the existing national requirements in the country of origin.

Thus, the eventual approval of this draft law poses a series of doubts and concerns for alternative investment fund managers, with the effect of further encouraging management companies specialized in hedge funds to revise their offer drastically by introducing harmonized UCITS III products.