

HIGHLIGHTS OF A WEB SEMINAR FOR SEI CLIENTS

The Changing Climate for European Funds: Regulatory Experts Weigh In

The marketplace for retail investment funds sold cross-border in Europe is being reshaped by regulatory change, most notably implementation of the UCITS III legislation. At a recent SEI Web seminar, international regulatory experts conducted a roundtable discussion on the far-reaching impacts of UCITS III and other developments affecting traditional and alternative fund managers.

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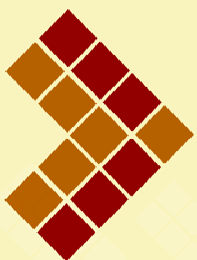
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Background

UCITS III is a good starting point for discussing the changing regulatory climate for fund managers in the European Union. For those less familiar with the European regulatory landscape, UCITS (the “Undertaking for the Collective Investment in Transferable Securities”) are the equivalent of U.S. mutual funds. From a U.S. regulatory perspective, the scope of UCITS legislation would be comparable to an amalgamation of the Investment Company and Investment Advisers Acts of 1940.

The key regulatory players referred to in the discussion are:

- **The European Commission (“EC” or “Commission”)**, the executive body of the European Union (“EU”). It acts as the guardian of the EU treaties to ensure that EU legislation is applied correctly, prepares policy initiatives and presents legislation suggestions, and is responsible for implementing new measures and directions for the EU.



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The Partnership is an initiative of SEI’s Investment Manager Services unit, which delivers operating solutions including fund accounting and administration, hedge fund services, and separate account services.



- **The Committee of European Securities Regulators (“CESR” or “Committee”)**, which is representative of regulatory bodies across Europe and is charged with advising the EC on implementation of the UCITS directive. Because CESR’s advice is typically accepted by the EC, the Committee’s consultation papers are very influential.

The following discussion provides practical insights into UCITS III, giving product sponsors perspective on product development and distribution strategies for UCITS in the EU. The discussion also uses UCITS III as a straw man to highlight some of the pros and cons of a hedge fund structure in comparison to a UCITS product structure.

How effective has UCITS III been in accomplishing its objectives?

The latest iteration of the UCITS legislation, UCITS III, has two primary objectives: (1) to increase and enhance cross-border marketing of UCITS; and (2) to move from a product-centric regulatory approach to a service provider-centric one.

Although it’s still early, UCITS III has been moderately effective to date. Its ultimate effectiveness will depend on cooperation among European regulators. In this regard, CESR has a critical role. Indeed, the ultimate success or failure of UCITS III depends quite heavily on CESR’s effectiveness in simplifying the registration process. Specifically, consolidation, harmonization and coordination of the filing process in the various EU jurisdictions are critical if the goal of enhancing cross-border marketing is to be realized.

In their consultation paper regarding UCITS III, European regulators noted that there have been 29,000 cross-border notifications by UCITS funds in Europe since the implementation of the first UCITS directive in 1985, so it is fair to conclude that the UCITS legislation hasn’t been a complete disaster. Still, even after UCITS III, there is broad agreement that too many differences among jurisdictions remain when it comes to registering funds outside of their jurisdiction of domicile.

“There is a real political commitment to making UCITS III work, which was not the case with UCITS I. That legislation made jurisdictions nervous about the potential for arbitraging different jurisdictions. This time around, regulators are committed to leveling the playing field.”

-David Dillon, Dillon Eustace

The goal is to create a single application form for registration across Europe. An effort is also being made to identify areas where there have been difficulties in the past. For example, in some jurisdictions you have to register every sub-fund of an umbrella fund, regardless of whether you intend to market all of the sub-funds in that jurisdiction. In other jurisdictions, you can register only the sub-fund you intend to market. These inconsistencies need to be eliminated.

Completion of a uniform, pan-European application form should greatly facilitate cross-border marketing of UCITS. Obviously, other issues such as differing tax treatments and local marketing rules also have an impact. But much can be done within the framework of the UCITS directive to simplify the registration process.

Will UCITS III spur product innovations to the degree expected?

In this regard, we are seeing a great deal of activity, a significant noise and heightened expectations. Nonetheless, it is still too early to say how much actual product innovation will result. European regulators have recently issued their recommendations to the EC, and in Ireland for example, the Irish regulator is starting to discuss issues such as the handling of risk management statements. UCITS’ use of hedge fund indices is another issue being debated. CESR has quashed that debate for the time being, having said it is not in a position at this time to satisfy itself that the actual indices to be used would meet the criteria set out in the Directive. However, CESR will be reviewing the issue in a year’s time. Exposure to commodity indices, on the other hand, is being allowed. So while there hasn’t been broad product proliferation yet, activity and interest are high.

One major change, and a huge step forward, is that UCITS funds can now invest in financial derivatives. As a result,



we are seeing quite a bit of interest in funds; use of these instruments to gain exposure to additional asset classes. For instance, we're seeing a growth in funds targeting a specific type of return over a specific period of time, and growing use of UCITS as a passport, if you will, to effectively distribute what would previously have been designed as a structured note.

There also is ongoing debate regarding expansion of the definition of transferable securities to include real estate or property-related securities down the road. The EC specifically addressed that question in one of its green papers, having asked for comment as to whether UCITS asset classes should be expanded. A majority of respondents expressed particular interest in real estate as an area UCITS should be permitted to invest in, so we may see some movement on that front.

"We can expect to see consideration of expanding UCITS to other asset classes, such as bank loan funds and real estate-related securities. But none of this will happen overnight."

-Michael Jackson, Matheson Ormsby Prentice

Is the industry seeking to push the boundaries on what types of investments are acceptable under UCITS III?

There certainly has been a move to explore hedge-like strategies, among other possibilities. But it's important to bear in mind that the leverage limits are still relatively tight for UCITS in comparison to traditional hedge funds. Effectively, a UCITS can now leverage up to 100% of its net asset value, which is much more than what was originally permissible but still poses some constraints. Also, there is still a prohibition on selling securities a fund doesn't own, effectively preventing short sales. Nonetheless, a UCITS can achieve a similar type of exposure through the use of derivative instruments and we are seeing UCITS starting to look into that.

Still, many UCITS are converting to UCITS III funds. To complete the conversion, many funds are focusing on very basic changes to their permissible investments, because more substantive changes would result in a much lengthier and more challenging regulatory review. Nevertheless,

there is no doubt that funds are going to use these strategies. They are working on it already.

Given the number of jurisdictions involved, how well is the process of interpretation working?

CESR has issued a number of papers in the two consultation periods, and it's important to recognize that the industry has been actively working to educate the Committee during this time. CESR's first position paper was quite conservative. Since then, there is been a subtle change and the Committee appears more willing to consider certain asset classes it would not consider previously. It's a slow process, given the number and diversity of jurisdictions involved, but the progress is encouraging. Things seem to be moving in the right direction.

It's true that there's no centralized interpretive body, so consistency of interpretation can be an issue. But at the same time, the EC has changed its legislative process, and what we've gone through with CESR is a good example of how that new process works. The idea is that where a directive is introduced, it should set out just the broad principles that the EC is trying to achieve. The detail of how those principles will be implemented across the member states is to be considered at lower levels. That approach allows the regulators to meet, discuss points of difference and work toward a common position which is then published for comment. So even though there is no central body, at these meetings regulators are very much pulled into line. The process is becoming more coherent. By and large, our experience has been that when a common position has been hammered out, the jurisdictions have implemented it.

"Some in the industry are concerned that the push for more consistent processes across Europe will result in a more conservative regulatory interpretation than we currently find in some jurisdictions. The challenge for the exporting jurisdictions is to try and push the boundary in terms of interpretation."

- David Dillon, Dillon Eustace

One danger, however, is that the process might produce an overly conservative result. A good example is in the UCITS definition of transferable securities and money market



instruments. Not until UCITS III have UCITS explicitly been permitted to invest in money market instruments. However, the reality is that many Irish funds, for example, have effectively been run as authorized liquidity funds because of the Irish regulator's interpretation under UCITS I. When the issue came up in the context of UCITS III, there was a sense that some of the regulators were being so conservative in their interpretation, there was some risk they would scale back what UCITS funds had already been permitted to do. Fortunately, the objective of UCITS III clearly is to enhance product innovation, not limit it.

Now these issues have largely been resolved, but it probably took more time and more effort than many industry participants believed was warranted. Therefore, it's important that in leveling the playing field, regulators don't lose sight of what and where the playing field is supposed to be.

How much are jurisdictions differing in their interpretations and their implementation of UCITS III?

It is important to note that in the early days of UCITS, there was a perception that if a jurisdiction didn't like your fund, the local regulator could simply block it for unofficial reasons on the basis that it was unlikely a fund promoter would want to institute proceedings against the regulator. For example, at one point, Spain effectively locked out Irish funds for what many viewed as a spurious reason. Now jurisdictions can't do that. If they don't like a fund, they can complain to the Commission but they can't refuse to approve your fund for distribution. CESR's role is critical in that regard.

The U.K. has participated actively at CESR and, indeed, has supported a number of the positions that the Irish and Luxembourg regulators have taken. So the process appears to be creating more consistency. The U.K., Ireland and Luxembourg are the jurisdictions that would usually support a more liberal interpretation of UCITS legislation. With London being such a major center of interest, the U.K. is being very active and making a big contribution to the implementation of UCITS III.

"There is still work to be done if there is to be a uniform fund registration process for all European jurisdictions. While the process is relatively prompt in some countries such as the U.K., it can take up to 100 days to register in certain countries."

- SEI Knowledge Partnership

In practice, the registration process is nominally the same in all of the jurisdictions. A fund files its application, and the regulator has two months in which to comment. The problem is that the two-month comment period starts from the beginning whenever comments or requests for documentation are issued. Some jurisdictions wait quite a while before requesting further information while others are more efficient.

This problem is one the European regulators are focusing on. It hopefully will be addressed in the simplified notification procedure and would benefit from the introduction of one common application form for registration across the various European jurisdictions. However, it appears as though a number of CESR members are objecting to the concept of the single application form for registration of UCITS.

"To characterize how much things have changed, under the old UCITS there were certain jurisdictions you could hardly get into. It was just a nightmare. Now getting into these jurisdictions is just irritating and expensive."

- Ethan Johnson, Morgan, Lewis & Bockius

How is UCITS III affecting management structures and governance?

This area is one of the most significant and dramatic areas of change resulting from UCITS III. Under UCITS I, firms attempted to access markets without investing a significant amount in infrastructure. Setting up a fund now entails much more than legal costs, because the infrastructure requirements are so much greater. There is also the requirement that certain functions must be overseen by at least two "named individuals" responsible for conducting the day-to-day business of the management company. The jury is still out on how this is going to end up. This issue is the subject of major debate in exporting jurisdictions such as Ireland and Luxembourg, where the industry is working for



as much flexibility as possible, partly by allocating actual functions among board members with support from administrators or special groups who provide reporting.

The worry is that this trend will creep into the requirements for non-UCITS funds. The industry is resisting that result, because the Irish and Luxembourg models, for example, have worked very well and provided for extremely strong corporate governance. The regulators seem to agree, but they are under pressure from much of Europe. That is why we are seeing much more emphasis on having people on the ground in the local jurisdiction. Managers don't want the requirements to move into the alternative side of the investment management business.

CESR is moving to look at these kinds of governance issues this year, but hasn't yet provided any guidance on them. One focus of debate is over management companies that delegate a large portion of their activities. There had been major debate over whether delegation should be allowed in the first place. Notwithstanding the industry's belief that we should not be forcing funds to perform within their organizations activities which, from the shareholder's perspective, are better performed elsewhere, some jurisdictions still want to limit the scope of delegation. Because the Irish and Luxembourg models allow delegation and history has revealed this model to be a successful and relatively incident-free model to date, the industry is hopeful that the CESR will pay heed to the Irish and Luxembourg regulators' positions.

What are early impressions of the effectiveness of the UCITS management directive?

The management directive may be the greatest disappointment concerning UCITS III. The idea was to introduce a passport for management companies so that, for example, an Irish-authorized management company could act as manager to a U.K.- or French-authorized UCITS. It has turned out that the regulators are not willing to permit this scenario, largely because they feel that having a fund's books and records kept in another jurisdiction would make it more difficult to exercise prudential supervision over the UCITS fund.

The management company passport will continue to be the subject of debate. It comes down to an interpretation of one

specific provision of the management company directive. Responses to the EC's green paper have stressed this as an area the EC should reconsider. There is some belief that the management company passport is something people should be able to avail themselves of on a broader basis than is currently permitted.

It's important to note that the product directive and the management directive really are two separate issues. From the point of view of an exporting jurisdiction, the management directive doesn't offer very much. In fact, it has brought certain extra capital requirements that don't make a lot of sense to an investment fund. For example, whereas we once had very flexible delegation rules, now they are much more onerous in terms of corporate governance requirements.

Will UCITS continue to be marketed in jurisdictions outside Europe?

Yes. It is true that certain jurisdictions in Asia have looked more favorably on registering or licensing UCITS than on your typical Cayman Islands-based fund, for example. We see quite a number of UCITS that are registered in places like Chile, and particularly in Hong Kong. The Hong Kong regulator traditionally has been quite favorable towards the UCITS structure, and some of the issues that have arisen around the use of financial derivative instruments have been resolved.

The Hong Kong regulator has also met with EU regulators on a number of occasions, and has gotten quite comfortable with the idea that if you are UCITS-compliant, the Hong Kong regulator will fast-track you. Nonetheless, it may take some time, because the Hong Kong regulator is wrestling with the risk management process at the moment. But once the regulator gets comfortable with the entire process, Hong Kong should be able to give priority to UCITS funds, and a number of other jurisdictions might follow suit.

The case can be made, however, that for non-European clients who are already having a difficult time adjusting to the UCITS format, it may not be worth the effort, since they can probably get into Hong Kong and other locations with only slight modifications to their existing products. There is also some concern that regulators in those locations might



change the legislation or their approach to not provide a bigger pass to UCITS, but then start restricting more of the traditional products they have been willing to license in the past.

Are the derivative valuation guidelines and risk management statement presenting difficult challenges for UCITS?

From the Irish perspective, this process is one that has involved much debate. Until recently, the regulator took quite a conservative view on the risk management process, and there was a robust exchange of views on the matter. Now we have come to a truce and a format that is reasonably well accepted by the industry. In the early days, the process of getting your risk management process approved was fraught with obstacles. It is now easier.

There was a great deal of input from the industry, and a real effort was made to sit down with the regulator and reach an acceptable middle ground. That outcome has largely been achieved. One of the positive outcomes was the regulator's agreement to distinguish between fairly straightforward and more complicated uses of financial derivative instruments.

Are funds converting to a UCITS structure because of perceived advantages in light of UCITS III?

We are seeing people who are setting up new funds considering the benefits of a UCITS structure, whereas before they would have launched them as non-UCITS funds. However, there are still some advantages to remaining a non-UCITS fund. Outside of the UCITS platform there is still greater flexibility in investment restrictions and in some of the procedural requirements.

"I think it's fair to say that currently, if you are targeting a sophisticated institutional market where you can sell based on the private placement rules, it may make sense to stay outside of UCITS, especially if you're targeting only a few jurisdictions"

- Michael Jackson, Matheson Ormsby Prentice

Traditional U.S.-based clients who manage hedge funds and are looking at Europe have typically found the UCITS regulations and directives too difficult to reconcile with their products. They have either gone with a privately-placed

product or have been able to design non-UCITS products for the countries in which they've registered. All in all, don't expect to see a huge rush of hedge fund managers setting up UCITS products.

What are some of the advantages and disadvantages of a non-UCITS structure?

Despite expansion of the definition of transferable securities, which has expanded a UCITS' permissible investments, it is possible to establish categories of non-UCITS, which essentially have no restrictions mandated by the regulator with respect to their investment or concentration limits as long as those investments are consistent with their offering documents. Similarly, although the leverage limits applicable to UCITS have been liberalized under UCITS III, non-UCITS sold to qualifying investors are not subject to any leverage limits. Investing consistent with the leverage limits disclosed in the offering document is the only practical limitation on leverage by a non-UCITS sold to qualifying investors. Non-UCITS also can invest in illiquid securities to a greater extent than UCITS. Again, the only practical limitation on illiquid investments by a hedge fund sold to qualifying investors being investing consistent with the offering document disclosure regarding illiquid investments.

"Despite expansion of the definition of transferable securities, which has expanded a UCITS' permissible investments, non-UCITS essentially have no restrictions with respect to the types of securities in which they invest as long as those investments are consistent with their offering documents."

- SEI Knowledge Partnership

On the other hand, the main disadvantage of a hedge fund structure is that interests in a hedge fund generally can only be purchased in a private placement. In addition, even though the UCITS passport is imperfect, there is no comparable passport for hedge funds. The improvements in the UCITS passport have spurred some consideration of whether or not there should be a passport for hedge funds regulated within the EU. There are also some moves toward the Commission's considering that possibility. At the same time, some jurisdictions are providing for some sort of regulated, registered hedge fund product. Ireland was the

first European jurisdiction to do that, Germany now provides for funds of funds and Spain has published its regulations for comment.

Over time, we may see moves to a type of non-UCITS passport for hedge funds. This was proposed to the Commission about eighteen months ago, and the reaction was “great, it will take ten years.” But since then, the pressure for that kind of action has increased. It may not happen in the next two or three years, but we will probably find proposals coming “on stream” reasonably soon to introduce a passport or to agree upon a common definition of what constitutes a private placement, which would greatly facilitate the sale of hedge funds.

What issues other than UCITS are currently affecting European hedge funds?

At the moment, the impact of the market abuse directive on investment funds generally is quite a hot topic in Europe. By way of background, the directive was introduced to update and consolidate EU law on insider dealing, market abuse, issues such as research and other regulatory recommendations. The directive certainly introduces new requirements in relation to the disclosure of price-sensitive information, and its definition of what is price-sensitive is quite wide-ranging.

One focus of debate right now is whether or not hedge funds are obliged to disclose the same portfolio information to all investors. Regulators are arguing that any information deemed to be price-sensitive must be disclosed to all investors. Effectively, price-sensitive information is defined as information that any reasonable investor will likely take into account in considering whether or not to purchase the securities. There are some exemptions. For example, if you have confidentiality commitments, you can disclose them. However, doing this restricts the person receiving the information from dealing in the funds. Managers, on the other hand, are arguing that in the context of an investment fund dealing at Net Asset Value, there are limited kinds of circumstances in which portfolio information would definitely have a material impact on price.

In any case, portfolio disclosure is very much an issue of concern. One change on this score has already occurred in Ireland, where regulators were trying to insist on full

portfolio disclosure. Now they are allowing a consolidated disclosure, so the regulators are getting a bit more pragmatic in their views.

Also, Germany has enacted some new hedge fund rules outside UCITS regulations. These rules include a tax reporting requirement specifying that fund returns be published annually in Germany’s federal gazette so investors can pay their taxes properly, etc. There was concern that this might require some types of funds to disclose their portfolios in the tax filing, but the legislation exempted most hedge funds from that reporting.

How are developments relating to the OTC valuation requirements and the prime brokerage guidance note impacting the hedge fund industry?

In Ireland, and in other European jurisdictions, what the OTC valuation requirement means in practical terms is really a counter-party valuation and then an independent third party valuation, which effectively is the investment manager. On the OTC side, the requirement to obtain counter-party valuations on a daily basis is obviously creating difficulties, so there is a move toward relaxing that requirement and allowing more reliance on the use of models to value OTC positions. That outcome would certainly be a change for the good.

In relation to the prime brokerage guidance note, it’s fair to say that the relaxation of rules concerning the amount of assets that can be delivered to the prime broker, particularly for qualified investor funds, has recently helped increase the number of Irish hedge funds obtaining authorization. The original limit of 100% of net assets was considered too low. The limit is now 140% for professional funds with no stated limit for qualifying funds. This change has encouraged people to take another look at using Ireland as a domicile for those types of products.

Conclusion

Although it’s too early for a definitive commentary, UCITS III has been moderately successful in achieving the product directive’s major goal of enhancing cross-border marketing of UCITS. The ultimate effectiveness of a UCITS passport will depend on cooperation among European regulators led by CESR. The success of the management company directive is much more in doubt at this time, with the



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governance requirements posing the biggest remaining challenge.

All in all, UCITS III is a step in the right direction for the EU retail fund industry. Nonetheless, UCITS remain subject to significant regulatory limitations, which continue to make a non-UCITS structure more appropriate for alternative investment strategies

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