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News from:

Across Europe

- The merger regime under UCITS IV
- CESR considers implementing measures on the MCP
- Side pockets and possible use by UCITS
- Hedge funds face increasing regulatory focus

United Kingdom

Luxembourg

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Introduction

Sean Quinn
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Welcome to the first 2009 edition of *European News & Views*! As I am drafting these notes, I cannot but think about how different a world it was when we were writing the last issue of our newsletter.

During the last few weeks, we have realised how the regulatory environment landscape has changed, if not yet in real terms, surely in terms of what is going to be expected of financial institutions. Increasing regulatory focus on alternative investments, credit-rating agencies and securitisation vehicles are not anymore hypotheses supported by the few, but fast becoming the reality for the many.

Additionally, the balance of regulatory power has further shifted from national regulators to European regulation. We were already cognisant of this fact, but the events of recent months have, without any doubt, accelerated the process.

In this issue of *European News & Views* we cover some of these aspects and more classic and familiar ones. On the UCITS IV front, we provide you with an analysis of the new UCITS mergers regime, based on the text of the directive as adopted in January by the European Parliament.

Always on UCITS IV, we review the contents of CESR's call of evidence on the Management Company Passport, whose implementation will have profound implications on the fund services provision value chain.

As markets become more and more volatile and some categories of assets become less liquid, some techniques emerge to ensure that the unavailability of prices or valuations for some instruments does not compromise the ability of a fund to produce a NAV and continue trading. We therefore look into side pockets, particularly how they may be established and under which circumstances, and review the available regulatory guidance with a focus on UCITS.

While side pockets are probably the latest alternative-funds characteristics to have been imported in the UCITS world, alternative funds themselves are also on the verge of being impacted upon by a typical characteristic of UCITS: a stricter regulatory environment.

Although most industry practitioners would share the view that private equity funds and hedge funds are already adequately regulated, the opinion seems to be emerging in Brussels that more may be needed to restore market confidence. In our article entitled "Hedge Funds Face Increased Regulatory Focus", we review some of the most recent initiatives in this area.

At the time of writing, we still did not have all the details of the proposed EC directive on alternative investment fund managers, which has been published on 29 April 2009. This directive will be a major step forward in establishing a harmonised European regime for alternative investments, which will surely bring benefits in terms of investor protection, although it has already received its share of criticism by some of those who have had access to preparatory documents.

At national level, we are providing you with a number of interesting updates.

For the UK, we analyse current updates to TCF, reviewing the latest FSA contributions and possible impact of the TCF regime on the fund business. We also provide you with a follow-up article on paperless settlement of Collective Investment Schemes. Finally, we analyse the impact of the recent market events on ICAAP, and review the key risks for asset managers, as identified in the FSA's latest Financial Risk Outlook.

For Luxembourg, we thank Lou Kiesch and Fabrice Delcourt from Deloitte Luxembourg for their interesting analysis of the Grand-Duchy fund business environment and of the challenges associated with the financial market turmoil.

Additionally, we provide you with an update on ALFI's recent guidance on the application of amortised cost to the valuation of money market instruments – a topic we analysed in detail in the previous edition of *European News & Views*, with reference to the Irish market.

The next months will bring additional challenges. The most obvious ones will focus on the implementation of UCITS IV (should it finally be approved as planned). While CESR has already started its Level 2/Level 3 work on a number of areas, work proceeds on matters such as risk management and the clarification of the role and liability of the depositary. At the same time, the industry will try to take steps forward in defining funds-processing platforms and standards to increase the efficiency of the fund-distribution process.

We hope you enjoy the reading and look forward to the next edition of *European News & Views*.

The merger regime under UCITS IV

One of the key elements of the UCITS IV package consists of the introduction of a regime for the merger of UCITS.[1] Along with master-feeder structures, mergers are seen as a viable tool for increasing the average asset size of UCITS and therefore generate economies of scale within the industry. In this article, we review the key features of this new regime and consider its implication for the depositary's function.

Definition of merger

UCITS IV provides a definition of merger under Article 37. Accordingly, a merger shall mean:

1. An operation whereby one or more UCITS or compartments thereof (merging UCITS) are dissolved and transfer all of their assets and liabilities to another UCITS or compartment thereof (receiving UCITS) in exchange for the issue to their unitholders of units of the receiving UCITS and, if applicable, a cash payment not exceeding 10 per cent of the net asset value of those units;

2. An operation whereby two or more UCITS or compartment thereof (merging UCITS) are dissolved and transfer all of their assets and liabilities to a UCITS that they form or a compartment thereof (receiving UCITS) in exchange for the issue to their unitholders of units of the receiving UCITS and, if applicable, a cash payment not exceeding 10 per cent of the net asset value of those units;

3. An operation whereby one or more UCITS or compartments thereof (merging UCITS), which continue to exist until the liabilities have been discharged, transfer their net assets to another compartment of the same UCITS, to a UCITS which they form or to another existing UCITS or a compartment thereof (receiving UCITS).

Article 48 provides additional clarification in respect of the three definitions above.

Right to merge and merger procedures

UCITS IV explicitly states that UCITS should be allowed to merge, either domestically or on a cross-border basis, on the basis of the procedures established under the UCITS directive.

In addition to the above, where national laws of Member States require unitholder approval for the merger, Member States shall ensure that such approval does not require more than 75 per cent of the votes actually cast by unitholders present or represented at the unitholders' general meeting.

The merging procedure established under UCITS IV consists of the key following steps.

1. A "merger file" should be submitted to the merging UCITS regulatory authorities for approval, prior to the merge. The merger file will be provided in a language familiar to both the merging UCITS and the receiving UCITS regulators, and will contain the following:
   - The common draft terms of the proposed merger, as approved by the merging UCITS and the receiving UCITS;
   - An updated version of the prospectus and key investor information of the receiving UCITS (if established in another state);
   - A statement of all concerned depositaries on the proposed merger (whose contents we will review further down in this article); and
   - A copy of the information that will be provided on the merger to the respective unitholders of the merging UCITS and of the receiving UCITS.

2. Once complete, the file will be immediately transmitted by the merging UCITS regulator to the receiving UCITS regulator. Following the transmission, the respective regulators shall consider the potential impact of the proposed merger on the unitholders of the merging UCITS and of the receiving UCITS, as well as assess the appropriateness of the information provided to the unitholders.

3. If satisfied, the authorities of the merging UCITS and of the receiving UCITS may (within 20 days following the receipt of the merger file) authorise the merger, as long as the following conditions are met:
   - The proposed merger complies with the relevant requirements of the directive;
   - The receiving UCITS has been notified to market its units in all Member States where the merging UCITS is either authorised or has been notified to market its units; and
   - The merging UCITS regulator and the receiving UCITS regulator are both satisfied with the proposed information for the unitholders, or, alternatively, the receiving UCITS regulator has not requested the unitholder information to be modified.

Contents of the common draft terms of the merger

UCITS IV includes a detailed description of the common draft terms of the merger, which shall set out:

1. The identification of the type of merger, and the UCITS involved;

2. The background and the rationale for the proposed merger;

3. The expected impact of the proposed merger on the unitholders of both the merging UCITS and the receiving UCITS;

4. The criteria adopted for the valuation of the assets and, where applicable, the liabilities;

5. The calculation method of the exchange ratio;

6. The planned effective date of the merger;

7. The rules applicable to the transfer of assets and the exchange of units; and

8. Where applicable, the rules or instruments of incorporation of the newly constituted receiving UCITS.

It should be noted that UCITS IV provides that the competent authorities may not require any additional information to be included in the common draft terms of mergers.

Role of the depositaries

We have already mentioned that the merger file shall include a statement by each of the depositaries of the merging and the receiving UCITS.

Accordingly, depositaries are required to confirm that they have verified compliance of some elements of the common draft terms of the merger (points 1), 6) and 7) respectively of the previous section) with the requirements of the Directive, and the fund rules or instruments of incorporation of their respective UCITS.

In additional to the above, Member States will entrust in their national laws either a depositary or an independent auditor with validating the following:

1. The criteria adopted for the valuation of the assets and, where applicable, the liabilities;

2. Where applicable, the cash payment per unit; and

3. The calculation method of the exchange ratio and the actual exchange ratio.

This validation, that will take the form of a report, will be available free of charge to the unitholders of all the concerned UCITS and their respective regulators.

Unitholders information, unitholders rights and merger costs

One of the key features of the proposed merger regime is that all concerned unitholders should receive, only after the proposed merger has been authorised by the competent regulators, a letter containing appropriate and accurate information on the proposed merger so as to enable them to make an informed judgement of the impact of the proposal on their investment.

All concerned unitholders will have the right to request – by no later than five working days prior to the calculation of the final exchange ratio, and without any charge other than those retained by the UCITS to cover disinvestment costs – the repurchase or redemption of their units or, where possible, to convert their units into units of another UCITS with similar investment policies and managed by the same management company.

Therefore, to allow unitholders enough time to ponder their decision, the merger information shall be provided to them at least 30 days before the last date for exercising their redemption, repurchase or conversion rights. UCITS IV includes a description of the contents of the investor information, under Article 43(3).

As far as merger costs are concerned, except in the case where a UCITS has not designated a management company (e.g. in the case of a self-managed UCITS), any legal, advisory or administrative costs associated with the preparation and the completion of the merger shall not be charged to the merging UCITS, the receiving UCITS or any of their unitholders.

Final considerations

As we quickly approach the date when UCITS IV will become a reality (the expectations are that it will be finally approved by mid 2009), its text gets closer and closer to its definitive wording.

The new merger regime, in conjunction with the master-feeder regime, has the potential of facilitating the pooling of assets and increasing the average UCITS asset size – probably something that under the current market conditions will be felt even more critically than before.

However, there are two areas where we consider the current text of UCITS IV could be further amended.

The first area relates to the role of the depositary, which we are afraid is too wide, and stretched to become a quasi-auditor and quasi-legal one.

The second area relates to Article 46, which deals with merger costs. Although we appreciate the fact that unitholders should not incur disproportionate costs, it seems reasonable to believe that a UCITS merger shall generate economies of scale and ultimately lower costs for the investors.

In addition to the above, it should be considered that while for a medium/large UCITS merger costs should not represent a material amount, this may not hold true for a management company (which, we understand, shall bear the costs). There is an obvious risk that the mergers regime may not be as successful as expected, most of all now, when financial institutions are very conscious of the impact of any expense on their financial statements.

Finally, some areas of UCITS IV still require a Level 2 and Level 3 clarification exercise. On 17 February 2009, the Committee of European Securities Regulators (CESR) published a call for evidence focusing also on some aspects of the merger regime (with particular reference to the content, format and distribution of the information letter for unitholders).[2]

Notes

[1] We reference to the text of UCITS IV as approved by the European Parliament on 13 January 2009.

[2] Call for evidence on possible implementing measures concerning the future UCITS Directive, CESR/09-179.

CESR considers implementing measures on the MCP

On 17 February 2009, the Committee of European Securities Regulators (CESR) published a call for evidence on UCITS IV implementing measures.[1] The call for evidence, which covers all areas of UCITS IV, is split into three parts: 1) request for technical advice on the level 2 measures related to the management company passport (MCP); 2) request for technical advice on the level 2 measures related to key investor information; and 3) request for technical advice on the level 2 measures related to fund mergers, master-feeder structures and the notification procedure. In this article, we will focus on level 2 measures related to the MCP, probably the most innovative element, from a fund services product offering point of view, of the UCITS IV package.

The current status of the MCP

Before we start reviewing the contents of CESR's call for evidence, we will review the current status of the MCP.

Those of you who have read our previous edition of *European News & Views* will recall that CESR had been requested by the European Commission (EC) to opine on the feasibility of introducing a fully functioning passport for management company services.[2]

CESR's advice had been that for such a passport to be functioning effectively, the following key requirements (among others) had to be met:

- The UCITS should be considered as domiciled in the Member State where it is first authorised, and where the depositary is based (or established, to allow branching);
- The UCITS should be subject to Home State supervision only;
- The management company may be based in any Member State, and be subject only to Home State supervision;
- A management company's outsourcing arrangements are under the responsibility of the management company regulatory authorities; and
- If availing itself of the passport, a management company should appoint a representative in the UCITS Home Member State (the "local point of contact"), mainly to act as liaison with the local authorities and with the UCITS' unitholders/shareholders.

The EC has taken into due account CESR's advice, and has actually gone a step further, as under the current draft text of UCITS IV the requirement for the management company to appoint a local point of contact in the Host Member State has been lifted.[3] Recital 17 of the draft UCITS IV Directive states that a management company providing its services to a UCITS authorised in another Member State should designate a person to act as contact with the UCITS regulatory authorities, but it "should not be obliged by the law of the UCITS Home Member State to have a local representative in that Member State".

Therefore, under the current text of UCITS IV, the MCP has been implemented in its entirety and without notable limitations. This may lead to groundbreaking developments in the organisation of the fund industry servicing value chain.

CESR's level 2 measures

CESR considers that a set of implementing rules on the MCP is now required, on areas such as organisational requirements, risk management, conflicts of interest and rules of conduct. An appropriate level of harmonisation will help building the necessary mutual confidence between regulators, prevent regulatory arbitrage and ensure a high level of investor protection. CESR's call for evidence therefore focuses on the following MCP areas:

- **Prudential rules and conflicts of interest.** Article 12 of UCITS IV requires level 2 measures to be introduced with reference to prudential rules and the management of conflicts of interests. CESR will therefore advise the EC on the definition of procedures and arrangements to be implemented by the management company, having regard to the nature of the UCITS it manages, to demonstrate having sound administrative and accounting procedures, control, and safeguard arrangements for electronic data processing and adequate internal control mechanisms. Such arrangements should also include rules for personal trading of its employees, and for investment of the management company's own funds. Likewise, CESR will define the conditions for the structure and the organisational requirements of a management company that are necessary for minimising conflicts of interests.

In connection with the above, CESR will also review, under the terms of article 14 of UCITS IV, rules of conduct to be observed by management companies. Such rules will aim at:

1. Defining the steps that management companies should take to identify, prevent, manage and/or disclose conflicts of interests, so as to establish criteria for determining the type of conflicts whose existence may damage the interests of the UCITS;
2. Establishing criteria for determining whether or not a management company is acting honestly and fairly and with due skill, care and diligence in the best interests of the UCITS; and
3. Defining conditions and principles that will ensure that a management company effectively employs the resources and procedures necessary for the proper performance of its business activities.

- **Measures to be taken by a depositary of a UCITS managed on a cross-border basis.** Depositaries play a vital role in safeguarding the interests of UCITS investors. UCITS IV therefore requires that when a UCITS is managed by a management company established in another Member State, a written agreement should be drawn up between the depositary and the management company regulating the flow of information necessary to the former for performing its functions. CESR is therefore requested to advise the EC on the following:

  1. The conditions that a depositary must meet to fulfil its duties under such management arrangements;
  2. The details to be included in the agreement between depositary and management company, and how the flow of information between the two parties should be regulated; and
  3. The law applicable to the agreement, in order to remove legal uncertainties.

- **Risk management.** The EC seeks advice on the conditions necessary for ensuring risk management frameworks are effective, relative to the size and scale of operations of UCITS, so as to ensure the effective identification, monitoring and management of risks. CESR is requested to particularly advise on the following:

  1. What the conditions governing risk management processes (RMPs) that can be employed by management companies should be, considering the categories of material risks that are relevant for UCITS.
  2. The principles governing the identification of the particular risks relevant for a particular UCITS related to each portfolio position and their contribution to the overall risk profile of the portfolio.
  3. The requirements concerning risk measurement methods, such as the conditions for the use of different methodologies in relation to the identified types of risk and the specific criteria under which these methodologies might be used.
  4. How to establish principles for RMPs to be employed in order to mitigate or otherwise manage and monitor the identified risks related to each portfolio position and their contribution to the overall risk of the portfolio. With particular reference to financial derivative instruments, CESR is requested to recommend principles for calculating the global exposure related to derivative instruments, and measures that UCITS must undertake to ensure that global exposure relating to financial derivative instruments does not exceed the total net value of its portfolio.

  In addition to the above, CESR is requested to clarify the rules applicable to the accurate and independent assessment of the value of over-the-counter (OTC) derivatives.

  Finally, CESR is requested to clarify the rules applicable to risk communication and reporting mechanisms to the regulatory authorities.

- **On-the-spot verification and investigation.** Taking inspiration from other financial services directives, in particular MiFID and the Market Abuse Directive,[4] UCITS IV introduces the possibility for a regulatory authority to conduct "on-the-spot verification and investigation" on the territory of another Member State. CESR is therefore requested to clarify the contents of the procedures to be followed when a regulatory authority wishes to avail itself of this right.

- **Exchange of information between authorities.** A correct and adequate exchange of information between authorities is crucial for the effective functioning of the MCP. CESR is asked to advise on the definition of the procedure to be followed when regulatory authorities intend to exchange information, and to indicate whether part of the information-exchange process should be more effectively regulated at level 3.

Conclusions

CESR's implementing measures are required to support the provision of management company services on a cross-border basis. However, the application of the new rules to all management situations will constitute an important contribution to the strengthening of the European regulatory framework in general.

Although the call for evidence has closed on 31 March 2009, CESR is requested to deliver its advice by 30 October. We can therefore expect an extensive consultation process, considering the technical complexity of the issues involved and that CESR's advice may have profound implications on the way UCITS are managed and the fund services provision is organised.

Citi Fiduciary Services will follow up closely on the regulatory process, and participate in the debate at national and European levels.

Notes

[1] Call for evidence on possible implementing measures concerning the future UCITS Directive, CESR/09-179.

[2] "UCITS IV: Where Does the Fund Industry Stand?", *European News & Views*, third edition, 2008.

[3] We refer to the draft text of UCITS IV adopted by the European Parliament on 13 January 2009.

[4] Markets in Financial Instruments Directive 2004/39/EC (MiFID) and Directive 2003/6/EC (Market Abuse Directive), respectively.

Side pockets and possible use by UCITS

In the past few years, we have seen an increasing use of hedge fund techniques in the UCITS industry: firstly with the introduction of UCITS III and the increased flexibility it brought in the use of derivatives; then with EC Recommendation 343 allowing implicitly synthetic short-selling techniques (hence the wave of 130/30 UCITS); and finally with the Eligible Assets Directive, which opened the gates to indirect investment into hedge fund indices and other non-conventional assets (through derivative on indices, or non-eligible asset-backed transferable securities).

All these innovations were introduced with the purpose of increasing a UCITS portfolio's performances, while retaining the generic principles of liquidity and risk spreading that are the key elements of this product.

However, widening the array of instruments and techniques available for UCITS has also increased the risk of UCITS investing into assets that may not be as liquid as initially thought.

In this article, we want to review another hedge fund characteristic that may be soon imported into UCITS – this time to provide additional safeguards for investors and to allow UCITS remaining at least partially liquid even in the most difficult market conditions.

Defining side pockets

The FSA describes side pockets as arrangements used by some offshore funds to cope with illiquid assets.[1] The assets in question are effectively ring-fenced within the fund and investors hold assets in the ring-fenced assets. If the investor subsequently disinvests from the fund, they may not receive redemption proceeds for the assets in the side pocket for many months. Holdings in side pockets may conflict with the ability of the manager to meet their own redemptions to investors.

The Irish Fund Industry Association (IFIA) provides a similar definition, describing a side pocket as a "mechanism by which illiquid assets may be removed from the portfolio of a particular fund or sub-fund".[2]

Side pockets are used by funds when a portion of the assets held in portfolio becomes illiquid. Those illiquid assets are segregated and investors are allowed to redeem their investments only in proportion with the liquid assets available.

At the same time, subscribers may be accepted on the basis of the value of the liquid assets only, but are not entitled to ownership of the assets held in side pockets.

Mechanisms for creating side pockets

From a practical point of view, a side pocket can be created using different techniques, as long as the following can be achieved:

1. The illiquid assets concerned are ring fenced and segregated from the rest of the fund's assets;
2. Investors are allowed to redeem their shares or units on the basis of the value of the liquid portion of the fund's portfolio;
3. New investors do not participate in a share of the segregated illiquid assets; and
4. Any NAV- or performance-based fee takes into due account the impact of the segregated assets so that correct remuneration is paid to all the fund's service providers.

The ring-fencing of the illiquid assets can take place in different manners. The one we have witnessed more frequently consists in the creation of a new share class within the fund, to which the illiquid assets to be ring-fenced are allocated. The investors in the fund receive shares of the newly created share class in exchange for shares of the fund and in proportion of their holdings.

By way of example, let us consider an investment fund with one share class and two investors only holding respectively 60 and 40 per cent of shares in the fund.

Assuming that assets representing 10 per cent of the value of the fund become illiquid and the fund's governing bodies decide a side pocket to be created, a new share class within the fund is established, whose shares or units are allocated to existing investors in exchange for shares of the fund.

Figures 1 and 2 provide a very simplified description of each fund structure and of the investors' shareholdership before and after the creation of a side pocket.

Figure 1
Before creation of the side pocket

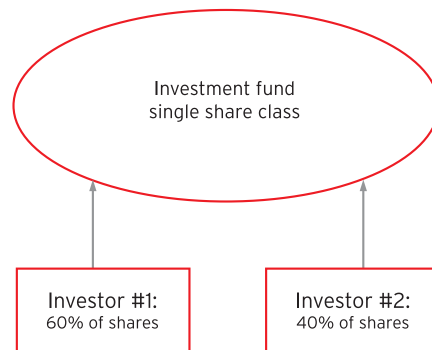
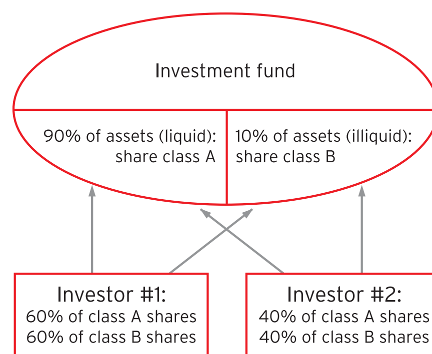


Figure 2
After creation of the side pocket



Fund shares representing investments into illiquid assets (class B shares in figure 2) are in principle not freely redeemable. When the illiquid assets (or part thereof) become liquid and can be realised or sold, the correspondent number of shares are liquidated, in exchange for cash or "normal" shares of the fund (class A shares in figure 2).

As one of the rationales for the creation of side pockets is to allow continuous trading of the fund's shares, new investors are only allowed to subscribe to the liquid share class. That also means that, should additional assets held by the fund become illiquid, other side pockets may be created using the same mechanism, and therefore some investors may eventually have a share of more than one side pocket.

Widening the array of instruments and techniques available for UCITS has increased the risk of UCITS investing into assets that may not be as liquid as initially thought.

It should also be noted that on occasion of the creation of the new share class or side pocket, fees payable by the fund are accrued in the side pocket in proportion to the value of the assets to be ring fenced. Likewise, any payment out of the fund for any expense will have to be accrued in the side pocket, although the cash will be paid out from the liquid share class. Accounting mechanisms will be established to ensure that each share class and, subsequently, each investor are treated equitably.

Regulatory considerations: UCITS framework

The UCITS directive provides no guidance in terms of side pockets. Although the UCITS framework is based on concepts such as "transferability" and "liquidity", little is said about which measures can or should be taken once some or all of the assets in which the fund is already invested are not anymore liquid, or cannot be valued (regardless of whether or not the value is a market price or a reliable independent valuation).[3]

Article 37 of the directive imposes UCITS to repurchase or redeem their units on unitholder request, unless exceptional circumstances impose a temporary suspension, which must be justified as having regards to the interest of the unitholders.

Article 38 of the directive states that the rules for the valuation of the assets and the rules for calculating the sale or issue price and the repurchase or redemption price of the units of a UCITS must be laid down in the law, in the fund rules or in the investment company's instruments of incorporation.

Finally, article 40 of the directive states that a UCITS unit may not be issued unless the equivalent of the net issue price is paid into the assets of the UCITS.

Although the directive does not make any reference to side pockets, it seems clear that those are not ruled out either a priori.

National regulatory interpretations

In Ireland, side pockets have been permitted by the Irish Stock Exchange for some years already with reference to investment funds applying for listing. Accordingly, the investment into special situations or illiquid investments through a separate share class should not exceed 30 per cent of the assets of the fund.[4]

More recently, the Irish Financial Regulator has stated[5] they would be willing to consider proposals by UCITS money-market funds to create side pockets, on a temporary, exceptional and case-by-case basis. It should be noted that no policy changes have been published in this respect.

In Luxembourg, we are aware that the CSSF allows the use of side pockets; however, this is done on an ad hoc basis and, for SIF[6] structures, usually under the condition that the side pocket does not represent the majority of the fund's assets. Again, no regulatory guidance has been published in this respect, nor are we aware of any UCITS having been allowed to make use of this technique. It should be considered, however, that in the past the CSSF has allowed partial redemptions for UCITS in exceptional circumstances where part of the portfolio had suddenly become totally illiquid.

Though the UCITS framework is based on concepts such as "transferability" and "liquidity", little is said about which measures can or should be taken once some or all of the assets in which the fund is already invested are not anymore liquid, or cannot be valued.

The Association Luxembourgeoise des Fonds d'Investissement (ALFI) has been working on a technical paper on side pockets, endorsed by the CSSF's, to establish a fast-track procedure for the approval of side pockets. The technical paper, which has just been published,[7] can be applied only if no more than 20 per cent of the concerned fund's assets are concerned.

The ALFI technical paper considers only two side-pocketing options: a spin-off from one or more existing share/unit class to one or more new share/unit

class, and a spin-off from an existing sub-fund to a new sub-fund, respectively.

The ALFI technical paper include guidance on information to be provided to the CSSF.

While we are not aware of particular guidance having been published in the UK, the French Autorité des Marchés Financiers (AMF) has published very recently recommendations addressed to local fund managers having been impacted by the "affaire Madoff".[8]

Accordingly, the AMF considers that if the impact (on any direct or indirect exposure towards entities linked or connected to the Madoff affair) on a fund is either not quantifiable or material, the concerned assets should be isolated in a side pocket, according to articles L. 214-19 and L. 214-30 (dealing suspensions and spinoffs for the case of a SICAV or of an FCP, respectively) of the French Financial and Monetary Code.

The above guidelines have been further clarified in a position paper.[9] Among other things, the AMF considers the following:

- **Regulatory approval.** In principle, no prior regulatory approval is required for the establishment of a side pocket. However, the AMF must be notified without undue delay, following a procedure as described in the Position Paper.
- **Shareholders/unitholders approval.** The investors should be immediately informed of the creation of the side pockets, in consideration of the fact that the spin-off requires EGM approval. The AMF stresses the fact that information should be provided to each investor. It should be noted that investors do not have a right to redeem free of charge, in consideration of the fact that the event does not have material impact on investors' rights.
- **Concerned assets.** There is no legal limitation to the nature of the assets that can be moved into a side pocket. However, any asset transfer should be done with the interests of the investors in mind and on an exceptional and limited basis. Additionally, the transferability of each asset has to be assessed on a case-by-case basis, as legal or contractual provisions may exist preventing their contribution or transfer to a new share class, subfund or legal entity.
- **Management of the assets.** The assets conferred to the side pocket should be managed in view of their sale, liquidation or maturity. Active management of the side pocket is therefore excluded a priori. It should also be considered that the side pocket might need liquid assets to be conferred by way of example to meet margin calls.

Governance, safeguards and oversight

Establishing a side pocket is a significant event in the life of an investment fund. It is important that appropriate control mechanisms and safeguards are put in place to avoid any misuse of this technique or any unfair treatment of investors.

As a basic principle, the mechanisms for creating, managing and extinguishing side pockets should not conflict with the prospectus, and be adequately disclosed in the offering memorandum and any relevant marketing material.

Such mechanisms should not only relate to the decision-making and/or governance process, but go so far as to clarify, for each share class and subfund, issues such as: determination of accruals before and following the creation of the side pockets; treatment of performance fees; valuation of illiquid assets at the time of the creation of the side pocket; oversight of the side pocket and of their contribution to the overall risk profile of the fund; considerations of investment-spreading rules; voting rights (in terms of the fund's shares and the ring-fenced assets if applicable); calculation of TERs; fund benchmarking against its peers; and the apportionment of leverage (when applicable) to the side pocket.

Establishing a side pocket is a significant event in the life of an investment fund. It is important appropriate control mechanisms and safeguards are in place to avoid misuse of this technique or unfair treatment of investors.

As side pockets substantially allow "bad" investments being parked outside a fund's portfolio, particular attention should be paid to ensuring that this technique is not misused by a fund manager to improve their performance, to review high watermarks or to increase the performance fees payable.

Any element of discretion should be eliminated as far as the ability of a fund manager to park assets in the side pocket is concerned.

Conclusions

From a theoretical point of view, nothing seems to prevent the establishment of side pockets under UCITS.

However, as this is not a fully established technique yet, some legal, regulatory, contractual, operational and tax issues are still in the process of being clarified.

Under all circumstances, this is a very useful technique should the recent market turbulences persist and cause more and more frequent UCITS dealing suspensions or increase to material levels the value of assets illiquid or impossible to price.

In those cases where the full liquidity of a UCITS cannot be ensured, side pockets may represent a valid tool to ensure at least partial liquidity and allow not only an outflow of assets but also an inflow for investors willing to subscribe on the basis of the fact that they do not participate in a share of non-liquid assets.

That said, we understand that some regulators consider the establishment of side pockets under UCITS only as an extrema ratio, due to the potential impact of any widespread use of side pockets on the UCITS brand.

As usual we will keep on following the regulatory debate and provide you updates in due course.

Notes

1. Consultation Paper CP07/6 on Funds of Alternative Investment Funds (March 2007).
2. IFIA newsletter, 20 August 2008.
3. Council Directive 85/611/EEC of 20 December 1985.
4. For specific guidance, refer to Irish Stock Exchange Policy Note 2/06, 28 April 2006.
5. According to information circulated by the Irish Fund Industry Association (IFIA).
6. Funds established under the Specialised Investment Fund (SIF) law of 13 February 2007.
7. Side pockets — fast-track procedures, special ALFI newsflash, 24 March 2009.
8. Recommendation de l'AMF à destination des sociétés de gestion gérant des OPCVM de droit français susceptibles d'etre impactés par l'affaire Madoff, 17 December 2008.
9. Questions réponses relatives aux scissions d'OPCVM décidées en application du deuxième alinéa de l'article L.214-19 ou du deuxième alinéa de l'article L.214-30 du code monétaire et financier, 22 December 2008.

Hedge funds face increasing regulatory focus

Hedge funds have been increasingly in the spotlight in the last few months. Discussions in the industry, among regulators and in the political arena, have been focusing on the role of these investment vehicles in the recent market turbulences. While some have identified hedge funds as the main culprits for the crisis, others consider that their presence has actually helped to mitigate the crisis, and others feel that hedge funds have exacerbated the crisis by increasing market volatility. All of these points of view are perfectly legitimate, and although they may seem irreconcilable, they point equally in the same direction: a better understanding of the role of these vehicles and of the mechanisms they use to interact with the financial markets is required.

It is therefore not surprising that international regulators, the European Parliament and the European Commission (EC) have all recently looked into providing more clarity in this matter. In this article, we want to review some of the most significant recent policy and regulatory initiatives.

IOSCO regulatory standards on funds of hedge funds

IOSCO has recently published a consultation report on regulatory standards on funds of hedge funds.[1]

The consultation, which has closed on 5 January 2009, follows from previous initiatives of IOSCO's Technical Committee Standing Committee on Investment Management, in particular its investigation on regulatory issues arising from the investment of retail investors into funds of hedge funds, which culminated in the publication of its final report on funds of hedge funds in June 2008.[2]

On the basis of the investigative work performed so far, IOSCO has developed and published in the consultation report some elements of international regulatory standards, as follows:

1. Methods by which managers of funds of hedge funds deal with liquidity risks.

   In a nutshell, IOSCO considers that in order to ensure investors' redemption requests can be met, the manager of a fund of hedge funds should ensure, on the one side, that adequately liquid assets are always held in portfolio by the fund of hedge funds and, on the other side, that the fund of hedge funds' liquidity is consistent with that of the underlying investments.

   Where limited redemption arrangements are put in place (such as redemption gates or redemption deferrals), these should be consistent with the fund of hedge fund's aims and objectives, and comply with the following basic criteria:

   (a) The conditions for the activation of any limited redemption arrangement should be clearly specified in the prospectus.

   (b) The limited redemption arrangement should be activated only in exceptional circumstances, and applied fairly and equitably.

   (c) Any decision to activate limited redemption arrangement should be taken on a collegial basis, i.e. pursuant to a process of checks and balances.

   Before and during any investment, the fund manager should also always consider whether conflicts of interest might arise between the underlying funds and any relevant parties (e.g. preferential rights assigned to certain investors).

2. The nature and the conditions of the due diligence process used by managers of funds of hedge funds prior to and during investment.

   IOSCO identifies three fundamental dimensions of the due diligence process:

   (a) **Elements to be constantly monitored and analysed by funds of hedge funds managers.** The fund manager should establish and implement appropriate due diligence procedures for due diligence reviews to be carried out before and during investment into a hedge fund. Such reviews should, on the basis of the fund of hedge fund's legal, accounting and disclosure requirements, focus on those elements that may be a source of risk for the fund itself and its investors. IOSCO identifies some of those elements, but it will be ultimately the responsibility of the fund manager to ensure that all the correct risk factors are properly identified and monitored.

   (b) **Resources, procedures and organisational structures required to carry out a proper and robust due diligence.** Documented procedures should be established, based upon qualitative and quantitative analysis of the underlying hedge fund's characteristics. The procedures and organisational structures should allow for adequate mechanisms for identification and reporting of anomalies, and for implementation of the relevant corrective actions. Finally, the implementation of these procedures requires adequate human and technical resources and the establishment of collegial decision-making processes where possible.

   (c) **Conditions for outsourcing the diligence process.** Before outsourcing any party of the due diligence process, the fund manger should determine any potential conflict of interest between the delegated entity and the fund manager or the underlying hedge funds, and whether the delegation is consistent with applicable legal or regulatory delegation principles.

Rasmussen and Lehne reports
In 2008, the European Parliament published two reports, commonly referred to as the Rasmussen report[3] and the Lehne report[4] (from the name of the respective rapporteurs), whose recommendations have significant potential impact on hedge funds.

To meet investors' redemption requests, fund of hedge funds managers should ensure adequately liquid assets are held in portfolio by the fund and the fund's liquidity is consistent with that of the underlying investments.

The Rasmussen report recognises that no unambiguous definition exist under Community law of hedge funds and private equity funds, and considers that in light of recent market turbulences, but also in light of concerns raised by the EU and national institutions long before the current crisis, regulatory action is required at the European level to ensure financial markets stability and investor protection.

The Rasmussen report puts forward five key recommendations that can be synthesised as follows:

1. **Financial stability, capital and universal regulatory coverage.**

   This recommendation can be broken down in different components. The first component relates to the need for any financial institution (including funds) to comply with capital requirements. A corollary of this requirement is that originators hold part of the securities they issue on their balance sheet.

   A second component relates to enhancing transparency, with particular focus on the activities of credit rating agencies and of prime brokers, and to criteria for valuation of illiquid instruments.

   The third component relates to the need to establish a harmonised regulatory framework, in particular in the area of venture capital and private equity.

2. **Transparency measures.**

   This recommendation relates mainly to the transparency of alternative investment vehicles vis-à-vis investors, focusing on disclosure and communication of relevant information in terms of fees structures, investment strategies and leverage, fund-raising rules, manager's remuneration and unitholder's identification.

   In addition to the above, the report suggests initiatives to limit or monitor pension funds investment into hedge funds and private equity funds, and initiatives to improve protection of companies being acquired by any such investment vehicle.

3. **Excessive debt measures.**

   This recommendation focuses on private equity and venture capital funds in particular, and suggests limiting the amount of leverage for both the fund and the target company, and introducing measures to avoid the target company's capital depletion ("asset stripping").

4. **Conflicts-of-interest measures.**

   This recommendation highlights the need to ensure credit rating agencies disclose any conflict of interest, and separate their rating business from any other service they provide for any security or entity they rate. In addition to the above, the report recommends the Commission to review the structure of financial services with the aim of eliminating any unlawful market concentration or barriers to new entrants.

5. **Existing financial services legislation.**

   Finally, the report recommends the Commission undertaking a review of existing EU legislation to identify any gap as regards the regulation of hedge funds and private equity funds.

The Lehne report is mainly focused on corporate governance arrangements, although it puts forward also additional recommendations and makes a clear distinction between recommendations targeting hedge funds, private equity funds or both.

1. On hedge funds specifically, the Lehne report asks the Commission to establish rules that enhance the voting polices of hedge funds, investigating in particular on the effect of techniques such as securities lending and voting on borrowed shares, and on indirect acquisition of voting rights via option arrangements.

2. On both hedge funds and private equity funds, the report suggests the Commission to promote transparency via legislative action. The report focuses in particular on transparency towards investors (disclosure of risks, of managers remuneration and of significant shareholdership and associated voting intentions) and target companies (disclosure of investment policy, rules to promote long-term and responsible investment strategies).

European Commission's consultation on hedge funds
On the occasion of a recent speech given at the Monetary Affairs Committee (ECON) of the European Parliament in Brussels on 1 December 2008, given in response to the recommendations included in the Rasmussen and Lehne reports, the European Commissioner for Internal Market and Services announced the establishment of a consultation process on hedge funds.

The consultation process, launched on 18 December 2008, aims at generating informed and evidenced views on a number of identified issues, and permitting a better appreciation of the way in which the European policy stance towards hedge funds should evolve.[5] The consultation (now closed) was followed by an open hearing organised in Brussels on 26 and 27 February 2009.

The issues identified by the EC include:

- No conclusive or exhaustive definition of "hedge fund" can be easily provided, nor can a common pattern in the way the hedge fund value chain is organised be identified.
- The need to reassess the systemic relevance of hedge funds, in terms not only of direct but also indirect relevance, such as the potential consequences of a hedge fund failure for systemically relevant institutions like prime brokers.
- The impact on market efficiency and the integrity of the activities of hedge funds such as short selling.
- The need to manage hedge funds' internal risks, such as conflicts of interest and liquidity risks.
- Transparency and investor protection: concerns have been raised in the past about information provided by hedge funds to investors on a pre-contractual and ongoing basis. This perceived or effective lack of information may not allow a correct assessment of the risk of the investments.

The responses to the consultation, along with the contents of the report of the High Level Expert Group chaired by Mr de Laroisière have served as a basis for the EC's regulatory response, which has materialised in the draft Alternative Investment Fund Manager directive, published on 29 April 2009.

IOSCO report on hedge funds oversight

The last published document we will review, in chronological order, is the IOSCO consultation report on hedge funds oversight.[6] This report makes preliminary recommendations for regulatory approaches that may be used to mitigate regulatory risks posed by hedge funds, and therefore focuses on three key areas:

1. The operating environment of hedge funds, highlighting the associated regulatory risks.
2. The review and illustration of the work and recommendations issued by IOSCO and other international organisations and regulators in this area.
3. Making preliminary recommendations for possible principles and actions that may serve to mitigate regulatory risks.

In this article, we will briefly review only areas 1 and 3 of the above.

Substantially in line with the EU's position that no conclusive or exhaustive definition of hedge fund can be provided, IOSCO has considered a number of indicative characteristics whose combination may contribute to identifying a hedge fund. Such factors are shown in the table below.

IOSCO hedge fund characteristics	
Borrowing and leverage restrictions are not applied, and there is intensive use of leverage.	Significant performance fees are paid to the manager in addition to the annual management fee.
Investors are typically permitted to redeem their interests on a periodic basis (e.g. quarterly, annually, semi-annually).	Derivatives are used, often for speculative purposes, and there is an ability to short-sell securities.
More diverse risks or complex underlying products are involved.	Significant own funds may be invested by the manager.

IOSCO hedge funds risks		
Inherent risks	Transparency, reporting and disclosure risks	Relates to lack of transparency regarding the fund to investors and other market participants such as counterparties and regulators.
Risks identified by recent market events	Compensation risks	Relates to conflicts of interests between fund managers and other market participants, particularly regarding manager remuneration.
	Leverage	Excessive leverage may transfer instability to the financial market, either by way of increasing losses incurred by investors and lenders in a failed hedge fund, or by way of the potential disorderly pricing of markets as funds rapidly unwind positions.
	Market behaviour and trading/investment strategy risks	Although hedge funds can help market stability by increasing liquidity and enhancing price discovery, their failure or significant distress may cause serious market disruption. Price discovery may be materially impacted if a significant provider of liquidity to the market is no longer willing or able to participate; trade execution becomes harder if there is an asymmetry in the market due to concentration of positions combined with forced unwinding; and settlement stresses may be introduced through the unwinding of complex structures.

Having identified hedge funds, IOSCO considers both their inherent risks (those relating to the activities of hedge funds) and other risks (those highlighted by recent market events). For each potential risk, IOSCO also reviews the current market practice, mitigating factors and the risks to the market, as shown in the table of hedge fund risks opposite.

IOSCO considers that despite existing regulatory standards, principles and domestic regimes, the question continues to be asked about how effective those standards, principles and regimes are, and how well they have been implemented in practice.

Also, as the hedge fund industry is highly global and mobile, any regulatory measures or standards need strong collective global action and application.

IOSCO identifies a number of possible recommendations that could help addressing current concerns, either by reiterating or strengthening existing regulatory standards and practices, or by suggesting additional ones, as follows:

- **Hedge fund counterparties.** Prime brokers and banks should have strong management controls over their exposures to hedge funds, and the ability to obtain sufficient information from hedge funds to properly evaluate their risks on an ongoing basis. Securities regulators should support hedge fund counterparties in obtaining the required non-public information,
- **Hedge fund managers.** A consistent and equivalent approach of regulators to hedge fund managers should be adopted as a matter of priority. Oversight on hedge fund managers should be risk-based, focused particularly on the systemically important and/or higher-risk hedge fund managers.
- **Hedge funds.** Direct regulation at hedge fund level could involve a registration/authorisation of the fund as well as its ongoing supervision.
- **Industry best practice.** A consolidated set of industry best-practice standards should supplement IOSCO's recommendations and be globally consistent.

IOSCO is expecting comments to this consultation report by no later than 30 April 2009. A final report will be published after the consideration of received comments.

Conclusions

Hedge funds represent a very significant proportion of the financial markets' assets; therefore it is not surprising that regulators and politicians look at them with interest.

Given that, in most of cases, they are non-regulated or lightly-regulated institutions, and often opaque due to their complex strategies and the need to ensure their trading patterns and techniques are not disclosed to competitors, there is always the risk that imposing excessive transparency requirements may undermine their very raison d'être.

The regulatory action proposed by the EC is practical, as it addresses some of the concerns raised by the general public and politicians while it tries to ensure that the hedge fund industry can expand and contribute to Europe's economic growth.

The open hearing organised at the end of February by the EC on private equity and hedge funds has shed light on three key issues: financial stability and market integrity, risk management and transparency, and regulatory options.

The publication, on 29 April 2009, of the draft Alternative Investment Fund Managers directive[7] is a significant development in the establishment of a coherent EU regulatory environment. The text will be subject to an extensive consultation process, which we will follow up closely in the next issues of *European News & Views*.

Notes

1. "Proposed elements of international regulatory standards on funds of hedge funds – Related issues based on best market practices – Consultation report", Technical Committee of the International Organisation of Securities Commission, October 2008.
2. "Report on funds of hedge funds – final report", Technical Committee of the International Organisation of Securities Commission, June 2008.
3. Report with recommendations to the Commission on hedge funds and private equity (2007/2238(INI)), European Parliament's Committee on Economic and Monetary Affairs.
4. Report with recommendations to the Commission on transparency of institutional investors (2007/2239(INI)), European Parliament's Committee on Legal Affairs.
5. Working document of the Commission Services (DG Internal Market) – Consultation Paper on Hedge Funds, 18 December 2008.
6. "Hedge funds oversight – Consultation report", Technical Committee of the International Organisation of Securities Commissions, March 2009.
7. Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers, COM(2009)207 final.

United Kingdom

Treating Customers Fairly

With the December 2008 deadline — set by the FSA for all firms to have their Treating Customers Fairly (TCF) initiatives in place — come and gone, it seems that now is a highly appropriate time to be considering some of the implications and developments arising from this central FSA strategy.[1]

What does the FSA mean by TCF? We can begin to assess this by looking at the origins of TCF and its direct relevance to the FSA's Principles for Businesses,[2] the fundamental obligations of firms under the regulatory system.

As well as Principles 1 (integrity) and 8 (conflicts of interest), others have been named as relevant by the FSA:

> TCF covers not just our Principle 6 ("a firm must pay due regard to the interests of its customers and treat them fairly") but also several of our other principles for businesses, including: Principle 2 (conducting business with due skill, care and diligence); Principle 3 (taking reasonable care to organise and control affairs responsibly and effectively with adequate risk management systems); Principle 7 (client information needs) and Principle 9 (suitability of its advice and discretionary decisions for customers).[3]

Now that the deadline has passed, the FSA expects firms to be able to demonstrate that they are consistently treating their customers fairly. TCF remains central to their retail strategy, and is a hugely important part of their retail agenda for consumer protection.

So that the FSA can judge the progress that has been made in this field, TCF assessments will be moved into its core supervisory work earlier than originally planned — from January rather than September 2009. Compliance with the December 2008 deadline will be assessed by ARROW, their risk-responsive operating framework.

For relationship-managed firms (i.e. firms supervised by the FSA on a continuous basis due to their size, activities and/or clients), TCF will become an integral part of regular assessments. These assessments will involve a review of TCF Outcomes with reference to a firm's own robust management information (MI), and direct testing of the consumer experience through methods such as call listening, mystery shopping, file reviews and reviews of consumer communications. For small firms (i.e. firms supervised reactively by the FSA through case work), progress will be monitored via the regional assessment programme under an enhanced strategy, over three years.

TCF remains the responsibility of senior management, using risk management structures and oversight, with the FSA expecting senior managers to challenge and assure themselves that customers are being treated fairly. The TCF initiative has been taken forward in an outcome-focused, more principles-based way.

The FSA has also clarified that a firm's ability to deliver fair treatment of customers depends on the culture that persists throughout that firm, and:

> We explained what we meant by "culture" in the context of Treating Customers Fairly in 2007 when we published a "culture tool", looking at some key factors which drive the firm's behaviour. These were: leadership; strategy; decision-making; controls (including the use and existence of appropriate MI); recruitment, training and competence; and reward.[4]

Tools that can be used to contribute include the following:

- Six TCF Outcomes;
- Product lifecycle (including guidance on provider distributor responsibilities);
- The TCF Culture Framework to help firms and the FSA to understand internal obstacles that prevent the good intentions of senior management and translating into improvements for consumers;
- Case studies; and
- Good and poor practice examples.

The six TCF Outcomes shown below try to explain what the FSA want TCF to achieve for consumers.

Six TCF Outcomes	
Outcome 1	Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
Outcome 2	Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
Outcome 3	Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
Outcome 4	Where consumers receive advice, the advice is suitable and takes account of their circumstances.
Outcome 5	Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.
Outcome 6	Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

For Collective Investment Schemes (CIS), there is some helpful advice on TCF on the Investment Management Association website, which provides documents covering "pointers and pitfalls (Do/Don'ts)", action checklists for managers in customer care and complaints-handling areas and current practice for larger, medium and smaller firms.[5] The FSA has also produced a TCF good practice guide for UK Authorised Collective Investment Scheme Managers – January 2008.[6] The guide provides some good-practice illustrations, along with several speeches on the subject.

The FSA TCF library also provides useful information for smaller firms covering "management behaviours such as leadership and dealing with customers", "management information", "demonstrating success" and "what is fairness?"[7]

The FSA deliberately do not offer a definition of fairness as they feel that it can mean different things to different people. They use an example of restaurant service and what a customer might expect from their experience, such as:

- Well trained and knowledgeable staff
- A menu you understand
- The opportunity to ask questions about the menu
- Getting what you expected and to the standard expected
- No surprises or hidden costs
- An accurate bill
- Not being taken ill later!

Basing TCF on outcomes and principles means that the Senior Management of firms must decide what is best for their own customers. The FSA will be reporting on TCF in their usual way in their Annual Report 2009, which will ultimately determine not only whether the industry has interpreted the principles correctly but reached the right outcome for their customers.

Conclusions

So, how can the TCF outcomes be achieved? That will probably depend on the nature of your business and the products that you market. Really there is no "one size fits all".

There are clues provided, however, from a surprising number of different sources. In fact, a thriving industry seems to have sprung up specialising in this very subject – companies offering software solutions, compliance advice, training, guides and checklists.

To conclude, we would like to quote the FSA again:

> We remain very focused on assessing firms against the TCF Outcomes going forward and taking tough action where we find short-falls. In our ongoing supervision, we will form our view of a firm's delivery with reference to that firm's management information (where we believe it is robust); direct testing of the consumer experience (for example through call listening, mystery shopping, file reviews, and reviews of consumer communications); and examination of any other relevant, up-to-date evidence (such as the results of recent thematic work). After many years of work, we would expect firms to be delivering a very strong performance. This does not mean 100 per cent delivery on all occasions, but – on rare occasions when things go wrong – we would expect senior management to have put in place clear accountabilities and timelines for taking action.[8]

It is our intention to revisit this subject in the future and consider some of the key practical implications and any developments as the FSA progresses with its assessment of firms and their TCF performance.

Notes

[1] FSA update on the Treating Customers Fairly initiative and the December deadline published by the FSA in November 2008.

[2] The Principles set out in the FSA Handbook under PRIN 2.1.1 R (Principles for Businesses).

[3] Speech by Sarah Wilson, Director, Treating Customers Fairly, FSA, from an ABI seminar for non-executive directors of insurance companies on 5 February 2009.

[4] Speech by Sarah Wilson, Director, Treating Customers Fairly, FSA, from an ABI seminar for non-executive directors of insurance companies on 5 February 2009.

[5] www.investmentuk.org, accessed (via membership login) on 24 March 2009.

[6] FSA Treating Customers Fairly and UK Authorised Collective Investment Scheme Managers Good practice illustrations for managers of UK authorised collective investment schemes relating to certain provider responsibilities identified in PS07/11 "Guidance on Responsibilities of Providers and Distributors for the fair treatment of customers" published in January 2008.

[7] www.fsa.gov.uk/Pages/Doing/Regulated/tcf/library/index.shtml, accessed on 24 March 2009.

[8] Speech by Sarah Wilson, Director, Treating Customers Fairly, FSA ABI seminar for Non-Executive Directors of insurance companies, 5 February 2009.

Paperless Collective Investment Schemes transactions

In the second edition of *European News & Views* in 2008, we discussed FSA proposals to facilitate paperless settlement for UK authorised funds. Progress has been made on a number of fronts so it seems appropriate to provide an update on the current position. The objectives of the proposals were, ultimately, to permit title to authorised funds to be transferred by way of an electronic communication and to allow registrars to accept and process such transfers subject to taking reasonable steps to ensure that instructions are genuine.

Legislation and Rule Amendments

Although amendments to the FSA COLL sourcebook were originally made following the consultation in May 2008, they were revoked when it became clear that the necessary amending legislation was not ready, and remade in the Collective Investment Schemes (Electronic Communications) Instrument 2009, which came into force on 6 February 2009.

The amending legislation, comprising the Unit Trusts (Electronic Communications) Order 2009 and the Open-Ended Investment Companies (Amendment) Regulations 2009 was eventually passed with enactment on 6 March.

Until these amendments, transfers of title to units and shares in UK authorised investment funds were to be made in writing. The newly introduced legislation permits transfer of title to authorised funds by electronic communication, and the OEIC Regulations specifically to permit acceptance and processing of such transfers by a registrar (having taken "reasonable steps" to ensure that an instruction is genuine).

It will be now possible for an agent to be appointed in writing to give electronic instructions on behalf of a holder (which is less burdensome than granting power of attorney – although exceptions may still apply for Authorised Unit Trusts registered in Northern Ireland or Scotland).

The sourcebook changes to COLL were limited, since electronic evidence of assent is already satisfactory, although the "reasonable steps" requirement has been added for transfers of AUTs that are to be effected on the strength of an electronic communication. There are more significant requirements for fund prospectuses to reflect whether or not electronic transfer instructions will be accepted, and, if so, under what conditions.

The newly introduced legislation permits transfer of title to authorised funds by electronic communication, and the OEIC Regulations specifically to permit acceptance and processing of such transfers by a registrar.

IMA guidance on "reasonable steps"

The Investment Management Association (IMA) prepared for publication detailed draft guidance on measures to satisfy the "reasonable steps" requirement mentioned above. In anticipation of enactment of the legislation, this was originally submitted to the FSA for consideration and approval in April 2008. This process included seeking the views of the Financial Services Consumer Panel. The approved document was published in draft form in August 2008, and on 9 April 2009 the FSA formally confirmed its introduction. Dan Waters, FSA director of retail policy & conduct risk, said:

> We are happy to confirm the IMA's Industry Guidance which will help fund managers to make the move from the current cumbersome paper-based transfer system to electronic dealing and settlement without weakening protection for unitholders. Industry Guidance gives firms help and advice on ways of complying with FSA principles and high-level rules, in a way that allows flexibility and innovation.[1]

The guidance suggests control mechanisms that registrars might employ in order to satisfy themselves that a holder (or someone properly appointed to act on their behalf) has authorised a transfer. This should ultimately contribute to more efficient processing for investors while providing (and demonstrating) adequate fraud protection for a firm and its investors. It should be noted that investors retain all existing rights to transfer or renounce title to units or shares by way of physically signed documents, which must continue to be handled in the normal way. As guidance, of course, the recommendations will not be mandatory, so alternative measures may be adopted if it is believed that they will satisfy these requirements.

The use of CREST for settlement

Our earlier article also referred to consequential changes that would ultimately facilitate the register and recognition of CREST functionality for funds. Euroclear UK & Ireland (EUI) and EMXCo launched a cash-settlement facility for funds last summer, using a feed from EMX into CREST to trigger settlement. Following consultation on a second phase, additional functionality is being developed to provide notional settlement of the stock in CREST (with legal register of title remaining with the fund's registrar).

The Euroclear UK & Ireland funds settlement "white book" – effectively EUI's final service description for the extended fund-settlement capability – was published

in January. This provides detail on what will be entailed in CREST settlement and how the interfaces will work. Some terms are a little strange, but should be considered in context. For example, the product provider is described as "counterparty" to transfers that involve movement of stock into or out of CREST, which is, of course, not the case in any legal sense, but they must be treated as such for the purpose of adding or removing the units in the system.

Clarification of some description of terms is still ongoing between IMA and EUI. Under "re-registration", when defining the types of transfer that it should be possible to process in CREST, the current reference to "no change of beneficial owner" seems incorrect. Since the purpose of this constraint is to exclude transfers that may incur stamp duty reserve tax (SDRT), this could also include gifts (i.e. transfers that involve change of beneficial ownership but not consideration).

It also appears that transfers between two CREST participant nominees may still require delivery of a stock transfer form – which seems to represent a missed opportunity to take full advantage of the paperless transfer regime. IMA believe that an understanding could be established between the parties involved so that the "Register Update Request" message may be construed as an electronic instruction from the transferor, and aim to work with EUI to determine how this might be established through agreements that firms sign with EUI and each other, as necessary.

Documentation

Firms will need to formally establish whether reliance can be placed on assurances from other regulated institutions that they have been appointed as a holder's agent for the purposes of giving transfer instructions or renunciation in electronic form. To support this, the IMA planned to prepare model clauses to be added to intermediary terms of business and agreements with fund platforms. Also, the existing model coverall renunciation arrangements effectively become redundant on adoption of the new capability and will need to be replaced.

It was hoped that this work would be completed before the legal and regulatory changes were implemented, but the unprecedented events of the autumn required more urgent attention of IMA resources. Discussions are now underway among the various interested parties, and a replacement for the model coverall, where different firms – e.g. an investment manager and a third-party custodian – undertake order placement and custody, should be finalised shortly. Other needs such as clauses for intermediary terms of business and model coveralls for dealer/custodian firms (such as fund platforms) should be met by derivations from this initial work.

Conclusion

All of the building blocks required for the full implementation of electronic transfer and settlement of Collective Investment Schemes (CIS) unit transactions are now in place or else significant efforts are underway to complete them. We will continue to monitor developments and advise of relevant progress through future newsflashes.

Notes

[1] "FSA confirms Industry Guidance designed to help more efficient transfer of investment fund units" (FSA, 9 April 2009).

Risk and ICAAP: the current agenda for asset managers

The FSA has recently published its Financial Risk Outlook (FRO),[1] in which the impact for financial sectors and consumers in the current financial and economic environment is considered, and awareness raised of the key issues facing both the FSA and the industry it regulates.

The scale of the crisis has raised major issues relating to the regulation and supervision of banks, other deposit-takers and bank-like institutions, and the FSA has already introduced – through its Supervisory Enhancement Programme – significant changes to its regulatory approach, although it is important to recognise that there are many aspects of regulation where there should be no need for major changes. The FRO acknowledges that a crucial fault in the years running up to the crisis was the failure to recognise large, system-wide risks and the dangers of a cycle of "irrational exuberance" – and that this was probably more critical than any deficiencies in the supervision of individual firms.

In the context of the current market environment, most firms will have needed to update their Internal Capital Adequacy Assessment Process (ICAAP) by the end of last year to ensure that it reflected not only changing business conditions, but also changing FSA expectations as to how those were addressed. The FRO included some critical observations[2] on the quality of submissions, so it is now all the more important to produce a thorough, well thought out ICAAP to demonstrate the robustness of a firm's control environment, and avoid the potential of increased supervisory scrutiny or capital loading.

The full senior management team must be conversant with ICAAP and the risk management framework – understanding should not be limited to compliance and control functions. They must ensure appropriate risk management is undertaken and that there is a clear understanding of the underlying risks to their business model. Firms need to be satisfied that key risks are appropriately managed and continually reassessed as conditions evolve, and it is of particular importance in this environment that they consider the implications of deteriorating economic conditions and the long-term viability of and weaknesses present in their business models. Ultimately, such scenario analysis needs to be embedded into day-to-day management of the business.

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The FSA recently[3] provided feedback on the conclusions from Supervisory Review Evaluation Process (SREP) reviews to date, as well as EU and international work on stress and scenario testing. Changes to Handbook rules and guidance on stress and scenario testing have been proposed, and are intended to be published in a Policy Statement in Q3 2009.

"Key risk" messages for asset managers

It is clear that the asset management industry will suffer from risks arising as a consequence of the current economic environment. The FSA identifies these, but also recognises and explores existing risks of ongoing importance.[4]

1. **Senior management need to consider carefully any cost-cutting exercises that could compromise essential functions, especially those in roles such as compliance, risk and audit, as well as back-office functions.**

   In an industry suffering as a result of the economic adjustment and difficult financial market conditions, efforts to cut costs may result in a weaker control environment among firms, and asset managers may not have adequate resources to manage the full range of investments in their portfolios. Asset management firms will face a decline in revenue as reduced "ad valorem" fees result from falling assets under management, primarily from reductions in prices of underlying asset classes. Net outflows as investors opt for lower-risk products will also contribute.

   The FSA anticipates that firms will look to offset these declines through cost reductions, but the higher fixed element of many firms' cost bases will make this challenging. A key risk is that such cost-cutting measures could result in weaker control environments. A strong control environment requires not just the robust performance of compliance, risk and audit functions, but also effective senior management engagement and oversight. Also, firms may not have adequate resources to allow them to robustly manage the full range of investments within their mandates. As OTC derivatives become more commonplace in portfolios, there is a risk of not being adequately resourced to monitor and manage these alongside traditional investments.

2. **Products should only be offered after careful development and once appropriate systems and controls are in place to support them. The nature of products (such as risk and return characteristics) should be accurately described, and reasonable care exercised over the distribution of products to mitigate the risk of mis-selling.**

The FSA expects interest in innovative asset management products to return, with new styles inevitable both during a downturn (as firms seek higher margins) and even more so during a recovery. There is a risk of a rush to market with copycat products, when firms may not perform adequately robust product development or resource themselves appropriately to provide and risk-manage a product. This may be compounded by cut backs on infrastructure forced by revenue pressures considered above.

Failure to understand inherent risks may lead to investors holding asset management products that are inappropriate for their needs. They may shy away from products perceived as higher risk and complex in favour of apparently more conservative products, but should be cognisant of potentially unappreciated risks. For example, absolute return funds can encompass a broad range of strategies ranging from hedge-fund style equity long/short strategies to complex multi-strategy fund-of-fund arrangements, so there may be underperformance in an equity market recovery, higher volatility than expected in different market conditions and failure to understand that an absolute return strategy aims for, but does not guarantee, a positive return.

Reduced risk appetite is likely to result in interest in funds promising a degree of capital preservation and structured products offering capital guarantees. Consumers may fail to understand the implicit costs of capital preservation in these funds, especially the likely reduction in total returns (compared with similar risk products) in the long term.

3. **Firms should have appropriate systems and controls in place to manage counterparty risk. They should understand the terms of engagement with counterparties, in particular conditions applying in the event of default.**

An increasing number of defaults over 2008 highlighted ongoing issues that asset managers faced, and will continue to face, in managing counterparty risk on behalf of their clients, particularly as it remains high in turbulent conditions.

During 2008, this risk crystallised in several ways. Firms incurred costs arising from replacing OTC derivative positions with bankrupt counterparties, in part due to having demanded insufficient collateral or rebalancing collateral too infrequently. Firms engaging in stock lending allowed cash collateral received to be invested in money-market instruments, which carried more risk than had been expected, reducing their ability to offset counterparty risk. Hedge funds posting assets as collateral in funding transactions also experienced difficulties in reclaiming these when counterparties had engaged in rehypothecation and subsequently went bankrupt. While firms may have expected such trades to have involved limited counterparty risk (given that many involved a central clearing counterparty), it materialised that administrative complexities resulted in some uncertainty for clients as to their position.

Firms also need to have robust contingency plans to address the risk of being unable to trade with a particular counterparty.

4. **Firms should consider stresses around potential client demand, and must be careful to treat investors equitably, especially when dealing with redemptions or transitioning assets between providers. Firms should analyse risks that could impact orderly wind-down, adequately quantify operational risks and demonstrate robust mitigation strategies for risks identified.**

The number of redemption requests by investors has increased, as volatile market behaviour has impaired the performance of funds. The challenge in dealing with high volumes illustrates the continued risk of failing to allow for investor demands for liquidity. While market conditions remain volatile, investors are likely to continue to favour high-quality liquid assets, but those that choose not to redeem are exposed to the risk of better-quality more-liquid assets being sold to fund withdrawals, potentially creating concentrations of investment risk that may be outside original expectations.

Reduced risk appetite is likely to result in interest in funds promising a degree of capital preservation and structured products offering capital guarantees. Consumers may fail to understand the implicit costs of capital preservation in these funds.

These pressures are likely to result in the wind-down or consolidation of funds, and potentially some firms. The complexity of some strategies may pose a risk to a firm's ability to manage an orderly and rapid wind-down. This will be a greater risk for smaller, thinly resourced firms or firms with particular concentrations in their business model, which may be highly reliant on a smaller client base who could withdraw their

assets or default on payments. In a period of continuing poor performance, there may be more claims against asset managers for failing to deliver on client expectations. Firms should also consider whether or not additional measures need to be taken to protect against reputational risk.

5. **Robust systems and controls must be maintained to guard against account takeover fraud, market abuse and fraudulent valuation of investments, and other financial crime.**

   There is higher risk of fraud at times of economic difficulty, and resource cuts at asset management firms and third-party service providers may intensify this risk. Market conditions may also heighten the risk of manipulation of the valuation of underlying investments in funds. Systems and controls for the management of the valuation process should also be in place so that questionable prices are identified. Demonstrating appropriate governance is also important when using non-independently sourced values, and firms should be able to perform due diligence on all assets and be able to monitor and manage the risks in portfolios in light of client mandates. The FSA expect this to be a key focus of auditors over the course of the year.

Conclusions

In the current financial and economic environment the subject of risk — and its identification, assessment and management — has never been more important and more open to regulatory scrutiny. It is therefore critical that a firm's control environment is demonstrably robust and derives from an embedded governance culture in order to meet FSA expectations. In doing so, and in responding proactively to the regulator's feedback from reviews and recommendations for improvements in the future, we will all ultimately contribute to — and benefit from — the restoration of confidence and stability in the financial system.

Notes

[1] Financial Risk Outlook 2009 (FSA, February 2009).

[2] Financial Risk Outlook 2009, p. 21.

[3] CP08/24: Stress and scenario testing (FSA, December 2008).

[4] Financial Risk Outlook 2009, pp. 69–73.

ALFI provides guidance on the use of amortised cost

In the last issue of *European News & Views*, we provided an update on the valuation of assets of money-market funds in Ireland, following publication of Guidance Note 01/08 by the Irish Financial Regulator.[1] In February 2009, the Association of the Luxembourg Fund Industry (ALFI) published guidance concerning the use of amortised cost instead of market value as a valuation basis, primarily for open-ended money-market funds. In this article, we will resume the legal background of ALFI's guidelines and their key features.

Legal background

For the case of a SICAV and of an FCP, respectively, in accordance with articles 28(4) and 9(3) of the Luxembourg UCI Law securities that are held in portfolio by a fund and whose latest quotation is not representative may be valued on the basis of the probable realisation value, which must be determined with care and in good faith.[2] On this basis, the Luxembourg CSSF accepts that the board of directors of a SICAV, or of the management company in the case of an FCP, may apply the amortised cost methodology for the valuation of money-market instruments with a final residual maturity of three months or less.

ALFI guidelines

On the basis of the current regulatory regime, ALFI considers that a SICAV or a management company, in order to avail itself of the amortised cost methodology, should comply with the following requisites:

1. Amortised cost may be applied only to securities bearing the highest-level credit rating.[3] In case of credit-rating downgrade, the concerned security should be immediately marked to market.

2. Structured investment vehicle (SIV) type instruments should be always marked to market.

3. Amortised cost may only be applied to securities with a final residual maturity of less than three months. By way of example, floating-rate notes with a reset falling within three months are not eligible (unless the reset date is the final maturity of the instrument).

4. The decision to value securities on an amortised-cost basis should be approved by the board of directors of the SICAV or of the management company (as applicable), and the rationale for the decision appropriately documented.

5. The application of amortised cost is made on the presumption that the concerned securities will be either held to maturity or are realisable at par. The fund's liquidity needs should therefore be carefully assessed and should any security reclassification to mark-to-market be required, such reclassification should be properly documented, reviewed and approved by the fund's governing bodies on a periodic basis. Any losses or gains arising from the reclassification should be dealt with on a consistent basis, one that is fair to all investors in the fund.

Conclusions

ALFI guidelines provide for basic of industry practice around the use of amortised cost by money-market funds. They do not impose any obligation to monitor discrepancies between market value and amortised cost on a regular basis, although they provide some guidance in terms of treatment of losses and gains in the case of securities reclassifications.

It would seem natural, however, for a SICAV or a Management Company applying the amortised cost methodology to perform regular comparisons between market value and amortised cost as part of the normal net asset value (NAV) sanity checks, to ensure no NAV price errors remain undetected.

Notes

[1] "Guidance Note 1/08: Valuation of Assets of Money Market Funds", *European News & Views*, third edition, 2008.

[2] Law of 20 December 2002 Relating to Undertakings for Collective Investments.

[3] Standard & Poor's A1+/A1, Moody's P1 or equivalent.

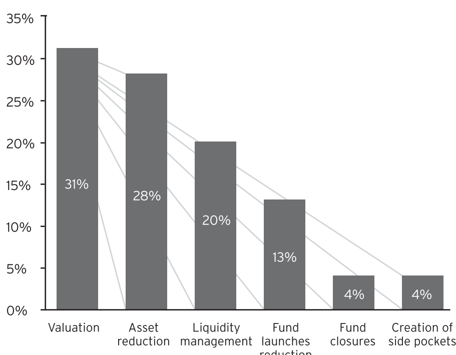
Looking back on Luxembourg . . .

Until the end of 2007, in the fund industry there were relatively serene feelings and a shared belief that the credit crunch would have limited effects in the long run and would be overcome – like previous crises – with a cocktail of cost consciousness, agility to innovate and patience. Admittedly the pace and impact of the crisis has been far more severe than most had anticipated. The combination of large redemptions (for particular asset classes) on the one hand and the illiquidity of significant portions of funds' assets on the other hand have created a situation far more complex than a "simple" market crash . . .

The various actors in the industry, such as management companies, depository banks, central administrations, fund promoters, lawyers and auditors, are being put to the test in terms of their reactivity and flexibility.

In particular, the asset-servicing industry has to cope with significant direct consequences. The diagram below shows the responses of Luxembourg's fund industry players to a recent market survey on their perception of the direct impacts of the crisis on their fund-related operations.[1]

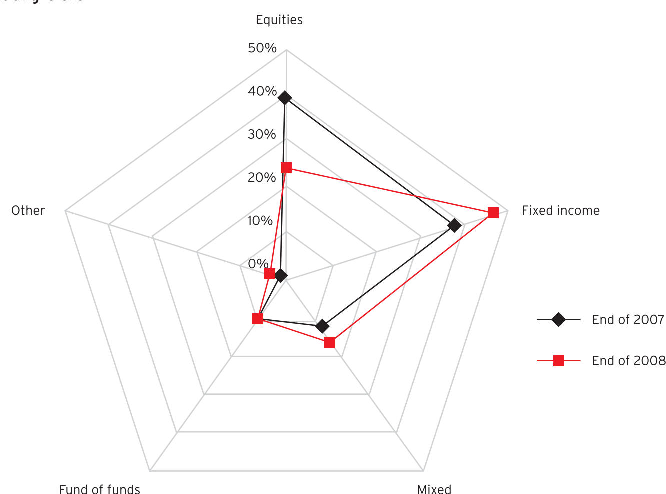
Percentage of respondents



Market effects and income streams

The statistics announced by Luxembourg regulator Commission de Surveillance du Secteur Financier (CSSF) as at the end of December 2008 showed total assets under management in Luxembourg UCIs amounting to EUR1.560 trillion, down from a record high of EUR2.059 trillion at the end of 2007.[2]

Asset mix in Luxembourg UCIs



Source: CSSF; Deloitte analysis

According to the recently issued figures, the drop in assets under management is explained firstly by the significant market value reductions and secondly, though to a lesser extent, by net redemptions effects. The fall in assets can be explained on an average monthly basis for the period between July and December 2008 by market effects for 7 per cent (equity funds) and 0.2 per cent (fixed-income funds) and by effects of net redemptions for 1.6 per cent (equity funds) and 0.8 per cent (fixed-income funds). In this, the diversity of asset classes and distribution channels served out of Luxembourg has helped limiting the damage and is likely to continue to do so.

Margins that have been under pressure for years due to increasing competition are being squeezed even further. During the four months to the end of 2008, Luxembourg funds suffered a reduction of 18 per cent of assets under management. Under such conditions, one may logically deduct that revenues to fund managers and service providers are in sharp decline at least in the same proportion. This trend is exacerbated by the change in product mix and the fact that those asset classes that have most suffered over the last months are those that generated the highest margins.

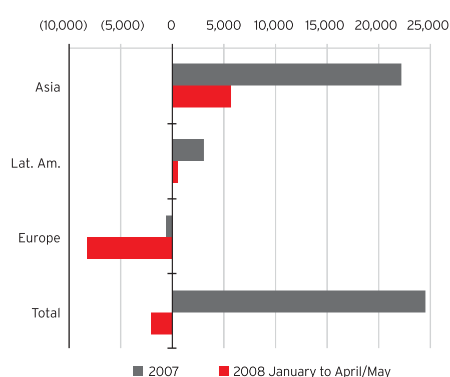
Reasons for optimism?

The fact that Luxembourg has emerged as the financial centre chosen by the largest fund-management houses to expand their global footprint implies that Luxembourg funds address the needs of a very large and diverse range of distribution networks and markets. Indeed, a survey by the European fund and Asset Management Association (EFAMA) showed in Q2 of last year that Asia was still a strong contributor, with positive net sales brought into European funds and Luxembourg UCITS in particular.[3]

In addition, a wind of optimism is still blowing across the industry, and, though funds under management are severely hit, the net creation of new funds in Luxembourg is still positive: the number of funds authorised by the Luxembourg regulator is up 18 per cent from December 2007 to December 2008. Although the number of UCITS vehicles has contracted only during the last two months of 2008, the dynamism of fund promoters and their faith in the attractiveness of the Luxembourg environment is evidenced by the steady increase in the number of

Specialised Investment Funds,[4] up by 46 per cent since the end of 2007. Nevertheless there is still room for additional gains of efficiency, and further restructuring of product ranges are expected.

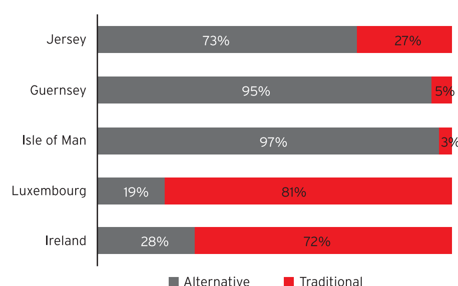
Net sales of UCITS domiciled in Luxembourg and Ireland by distribution area (euro millions)



Source: EFAMA

It is also worth noting that Luxembourg funds have had historically lower exposure to alternative strategies with a total value of assets under management in single hedge funds, fund of hedge funds and other alternative strategies and asset classes representing a fairly lower proportion of total assets under management than in other fund centres[6] as shown in the following chart.

Funds under administration — asset mix



Managing outflows and illiquidity: can investor behaviour be anticipated?

It is certainly not the first turmoil that the Luxembourg fund industry has had to traverse, and it has already navigated through rough seas. The burst of the technology bubble in 2001/03 also caused sudden and significant outflows in the equities markets. During this period, many Luxembourg funds suffered large net redemptions and central administrations were under considerable pressure to cope with such volumes. The crisis we are facing today is different in essence and is made even more acute by the additional complexity resulting from the illiquidity of some securities in the portfolios.

One might wish to be in a position to anticipate investor behaviour in such market conditions. Indeed it is paramount that actors in the fund industry should ensure that, irrespective of circumstances, investors are treated fairly and, as far as practical, are protected from large and frequent capital activity within the funds.

The French regulatory body for the financial sector, the *Autorité des Marchés Financiers*, recently released a study that analysed whether the investment behaviour of retail and institutional investors during a financial crisis could be better understood or even anticipated. They also analysed whether the behavioural impacts in terms of investor and investments protection could be mitigated by way of regulatory measures. The study used significant statistical data and techniques to analyse the potential pro-cyclicality of investment behaviour during the 2007/08 financial turmoil, i.e. the tendency to invest or disinvest, following market ups and downs.[6]

In the conclusion, the authors state that, "The fund inflows measured on this basis show that, even in times of crisis, investment behaviour patterns are very heterogeneous and defy general characterisation. . . . Furthermore, this poorness of fit reveals the weaker explanatory powers during a crisis of a number of variables, such as performance indicators, that ordinarily play a more significant role."

They go on to state, "Pro-cyclical investment behaviour is not a uniform phenomenon, even within homogenous investment fund categories. Taking measures to limit the harm to investors from massive and simultaneous investment outflows in illiquid markets is only conceivable under exceptional circumstances and when duly warranted."

It appears that whether or not investor behaviour can be anticipated cannot be answered merely by way of statistical studies. In the absence of any reliable mechanism or paradigm to anticipate fund in- or outflows, and therefore any general mitigating measures that can be proposed by regulatory bodies, it is incumbent upon fund service providers to ensure that the combined effects of outflows and illiquidity are addressed and mitigated through procedures that apply mainly on two levels: pricing mechanisms and protective measures.

Pricing mechanisms

The increased risks associated with liquidity and pricing issues require greater operational effort and oversight resources and have triggered an increase in the level of responsibilities demanded from pricing committees. Traditionally market players have emphasised the importance of strong pricing procedures that allow scrubbing multiple sources of price feeds and monitor potential differences between suppliers and, where appropriate, challenge the predefined hierarchies.

On the same note, it was a widespread market practice to have pricing committees and fair-value committees in place that, until the 2007 credit crunch, acted mainly as "governance boards" for securities pricing procedures. It is now a fact that in the context of the frequent shift from mark-to-market to mark-to-model pricing procedures (and the internal guesswork and assumptions that it implies), the responsibilities lying on their shoulders have reached higher levels, as they are more and more frequently solicited to make pricing decisions and judgment calls.

Protective measures

The spectrum of protective measures available to management companies to protect long-standing investors from large redemptions has been built over many years through specific measures facilitated by the regulatory authorities and flexibility imbedded in prospectuses in the form of: anti-dilution mechanisms, deferral of redemptions execution and finally "close-the-gate" (suspending the NAV for one or many days). More recently, the market place has shown again its capacity to innovate and protect the funds with the allowance of side pockets that allow for continuing to honour redemption requests while isolating problematic or illiquid assets.

In managing the impacts of significant outflows, management companies and service providers had two main concerns in mind: on the one hand, protecting those investors that remained in the funds and might suffer from additional costs and a diluted performance; on the other, ensuring that less liquid assets could be valued fairly or disposed of without materializing additional losses.

For the first aspect, different variations around the theme of anti-dilution procedures have proven to be particularly useful measures to protect long-term investors.[7]

Dilution corresponds with the transaction costs incurred when a fund manager has to buy or sell securities as a result of large capital movements into/out of a fund. Significant net capital movements, positive or negative, generate dilution, but it is marginal most of the time. In current times, it is almost a must to have in place such measures, as they allow for compensating the dilution of performance and, particularly important for funds investing in securities with large spreads (i.e. emerging-market bonds), investments in countries with high fiscal duties or with high brokerage fees (i.e. emerging markets), while treating all investors equally. Whichever form of anti-dilution mechanism is implemented shall depend upon the sophistication of the fund administration infrastructure. But we see even clearer indications that these shall not be considered "nice to have" in the future, and those promoters who adopted such measures prior to the crisis are now reaping benefits that they had not even anticipated.

As far as managing large redemptions, many management companies and central administrations had to cope with the application of redemptions deferrals. Although there are reasonably standard provisions in UCITS prospectuses allowing directors, the management company or its delegate to defer redemptions when the size of the redemptions requests exceed a given percentage of the NAV, these were essentially there to protect smaller funds or funds that are in the beginning of their life cycle.

In these difficult times, these procedures had to apply more frequently. There are, however, differences as to some of their features.

Firstly there are differences in terms of the percentage of net asset value or of the number of shares in issue that trigger such procedures (based on our observations and depending upon the category of assets these percentages typically range between 5 per cent and up to 30 per cent).

And secondly there are differences in terms of the flexibility allowed to directors, as they may either request to postpone redemptions demands to the next valuation date – or over a longer period (e.g. up to 3 consecutive dealing days) or simply decide it to their discretion, provided it is in the best interests of the remaining investors and it does not exceed for example 10 business days – or in certain cases they may reduce the redemption requests pro rata.

No doubt that in the future, these provisions will also be subject to tighter scrutiny by investors prior to engaging into any investment in any type of fund.

What can we conclude?

It is certain that the fund industry is suffering significantly and will need to operate with tighter margins in an increasingly demanding environment. Management companies and their service providers are not without tools to help face these and other challenges. The full set of measures that may be used to counter and mitigate adverse effects of the situation are being utilised and will continue to develop – e.g. anti-dilution mechanisms, specific dilution levy for liquidity crunch, deferrals of redemptions, side-pocketing illiquid assets and suspension of dealings, among others.

The industry still has a long way to go to ensure that both retail and institutional investor education on the products, their features and their suitability is set at a level that aims to prevent massive flows of capital and immediate reactions to short-term market movements which might result in realising investors' losses too quickly and ultimately affect financial stability, at least to a certain extent.

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Notes

[1] Deloitte's 2008 survey (*Fund Administration in Europe*) was conducted with 63 companies in Luxembourg, Ireland, Jersey, Guernsey and the Isle of Man, representing approximately 70 per cent of assets under administration in those jurisdictions.

[2] Statistics released by CSSF as at end December 2008.

[3] "UCITS as a Global Brand: an Industry Survey by EFAMA", July 2008: a survey of 28 UCITS industry players.

[4] Under the regime of the law dated 13 February 2007.

[5] Deloitte, Fund Administration in Europe 2008.

[6] Laurent Grillet-Aubert and Ramatoulaye Sow, "Are Net Fund Inflows More Procyclical in a Crisis?", *Working Papers*, No. 7 (France: Autorité des Marchés Financiers Research Department, February 2009).

[7] Anti-dilution procedures:
1. Systematic spreads: apply a systematic commission to subscriptions and redemptions in favour of the fund.
2. Dilution levy: apply a commission to subscriptions and redemptions in favour of the fund if net cash flows exceed a specific threshold.
3. Full-swinging: the NAV is adjusted each time there is capital activity. The direction of the swing is determined by the net capital flows of the day.
4. Semi-swinging: the NAV is swung as for full swing but only when a predetermined net capital activity threshold (i.e. the swing threshold) is exceeded.

Glossary

ALFI Association Luxembourgeoise des Fonds d'Investissement (Association of the Luxembourg Fund Industry)

AMF Autorité des Marchés Financiers (French financial regulator)

AUT Authorised Unit Trust scheme

CESR Committee of European Securities Regulators

CIS Collective Investment Scheme

CSSF Commission de Surveillance du Secteur Financier (Luxembourg financial regulator)

EC European Commission

EFAMA European Fund and Asset Management Association

EGM Extraordinary General Meeting

EU European Union

EUI Euroclear UK & Ireland

FCP Fond Commun de Placement (Collective Investment Fund)

Financial Regulator Irish financial regulator (formerly IFSRA)

FRO Financial Risk Outlook

FSA Financial Services Authority (UK financial regulator)

ICAAP Internal Capital Adequacy Assessment Process

IFIA Irish Fund Industry Association

IMA Investment Management Association (UK)

IOSCO International Organisation of Securities Commissions

MCP Management Company Passport

MI Management Information

MiFID Markets in Financial Instruments Directive

NAV Net Asset Value

OTC Over-the-counter

RMP Risk Management Process

SDRT Stamp Duty Reserve Tax

SICAV Société d'Investissement à Capitale Variable (Investment Company with Variable Capital)

SREP Supervisory Review Evaluation Process

TCF Treating Customers Fairly

TER Total Expense Ratio

SIF Specialised Investment Fund (Fond d'Investissement Specialisé)

SIV Structured Investment Vehicle

UCITS Undertaking for Collective Investment in Transferable Securities

UCITS III Current text in force of the UCITS Directive

UCITS IV Draft new text of the UCITS Directive

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