Clients&FriendsMemo

Regulatory Issues For European Funds: Updates on Synthetic ETFs and the Implementation of UCITS IV

20 June 2011

A. Synthetic ETFs

A recent Financial Stability Board note ("Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs)"[1]) has raised, not for the first time, the risks to investors supposedly inherent in synthetic ETFs and whether or not those risks require active management by regulatory authorities. Given the focus on counterparty risk post-Lehman, and on the need to protect retail investors investing in "complex" products, the question is being asked again as to whether or not the particular risks generated by these funds require special mitigating measures and restraints.

Cash-based, or "physical" ETFs, replicate a chosen index by reconstituting the index through the purchase of the relevant elements that go into making up that index. Synthetic ETFs aim to achieve the same result, but *via* an asset swap with a counterparty, with that counterparty being often (but not always) a member of the same corporate group as the asset manager. The advantage of the synthetic structure is the avoidance of both the potential for tracking error and the costs consequences of rebalancing and corporate actions (which plain vanilla ETFs tend to manage using securities lending revenues).

The risks engendered by the synthetic structure are clear:

(i) The investor is exposed to the risk profile of the swap counterparty (which is usually an investment bank);

(ii) The swap counterparty is often, not always, a member of the same group as the asset manager (the so-called "unfunded" swap – note that some "fully-funded" synthetic ETFs do use multiple, third-party counterparties and manage the collateral outside the fund, again using a third-party collateral manager) which in itself may create conflicts issues;

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[1] 12 April 2011

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(iii) The quality and liquidity of the collateral provided by the swap counterparty is key. That collateral is usually unrelated to the index which the ETF is tracking, and the Financial Stability Board has voiced a generalised concern that "as there is no requirement for the collateral composition to match the assets of the tracked index, the synthetic ETF creation process may be driven by the possibility for the bank to raise funding against an illiquid portfolio that cannot otherwise be financed in the repo market";

(iv) Given the potential illiquidity of the collateral basket, the question must be asked as to the effect of an investor run on a particular, or several synthetic ETFs and/or a counterparty default;

(v) UCITS III caps a regulated fund's total counterparty exposure to 10% of NAV, meaning that the swap counterparty or counterparties must always provide collateral of at least 90% of NAV. While many ETFs require over-collateralisation, some do not, and there is at least the potential for up to 10% under-collateralisation in the event of a counterparty default; and

(vi) Though many synthetic ETFs are aimed at the professional investor, there is a real concern over the level of understanding investors have as to what they are investing in, *i.e.* a basket of collateral securities that does not replicate, and may bear no relation to, the index the performance of which the ETF is tracking and reliance on derivative contracts. It is also unclear as to the level of investor understanding of the potential conflicts of interest inherent in unfunded swaps between members of the same group.

These concerns are clearly not limited to Europe. In March 2010, the SEC committed to review the use of derivatives by ETFs and deferred consideration of new and pending requests for the authorisation of ETFs that make use of derivatives. We anticipate that there will be at least some regulatory intervention in synthetic ETFs, possibly in relation to pre-sale disclosures to investors, particularly given the fact that the Financial Stability Board is not the only source of concerns about this market.

B. UCITS IV

UCITS IV is due for transposition into national law by 1 July 2011. It looks to achieve six significant changes or improvements to the existing regulatory framework and procedures for selling retail regulated funds in Europe to ease cross-border UCITS activities:

1. The introduction of a management company passport;

2. Improved investor disclosures through the Key Investor Information document (KII);

3. A quicker and easier process around cross-border marketing of UCITS;

4. A framework for mergers between UCITS;

5. Provision for master-feeder structures; and

6. Improved cooperation between national regulators.

The Management Company Passport

The passport will operate to allow an asset management company authorised in a single EEA Member State to operate a fund that is authorised in another member state by splitting responsibility for supervision between the Home State of the asset manager and the Home State of the UCITS. Such an asset manager will be able to manage UCITS in several Member States from a single location, a change which is likely to result in economies of scale for large asset management groups. Accordingly, a UK based asset manager would be able to manage a French FCP, an Irish unit trust and a Luxembourg SICAV simultaneously from an office situated in the UK. The measure should, very broadly, assist the competitiveness of the UK as a location for asset management operations. The depository must, however, still be situated in the same Member State as the UCITS. To facilitate the passport, the Directive also harmonises certain rules governing management companies. In particular, the Directive addresses rules on organisational requirements, conflicts of interest procedures, conduct of business and risk management.[2] Note that the latter requirement includes new rules on calculating exposures to derivatives counterparties and exposures created by and the cover required for derivatives and forward contracts.

A joint H.M. Treasury/FSA consultation document, published December 2010, also anticipated ensuring that there will be no adverse UK tax consequences for the foreign UCITS fund as a result of having a UK resident management company[3]. Clause 59 of the Finance Bill 2011 has since introduced legislation in this context, inserting a new section 363A into the Taxation (International and Other Provisions) Act 2010 to treat funds authorised under article 5 of the UCITS IV Directive as being tax resident in the Member State where they were authorised, and not as being tax resident in the UK as a result of having a UK resident management company. This clause was agreed, without amendment, in the Finance Bill 2011 by the Public Bill Committee on 7 June 2011 and should come into law on Royal Asset to the Finance Bill 2011 being given later this summer.

Key Investor Information

This replaces the current simplified prospectus, and is a pre-sale disclosure that must be of limited length and include concise information on the UCITS investment objectives and policy, past performance, charges and risk/reward profile.

[2] See the level 2 Directive for detailed rule requirements (Commission Directive 2010/43/EU).

[3] See *"HM Treasury/ FSA Transposition of UCITS IV: Consultation Document"*, December 2010, paragraph 9.4.

Cross-border marketing

Responding to concerns over bottlenecks, regulator-to-regulator notifications of cross-border marketing of UCITS should now take a maximum of 10 working days. Contents of the notification are now harmonised, and once transmitted, the UCITS may begin to market its units in the host state without the prior approval of that host state's regulator.

Mergers

UCITS IV looks to facilitate cross-border mergers between funds (including mergers involving UCITS based in the same Member State where at least one of the funds involved uses the passport to market into another Member State) by introducing a harmonised framework for their recognition. Mergers are subject to the prior authorisation of the regulator in the Member State of the UCITS that will cease to exist, and the merger must also be approved by unitholders. Costs of the merger may not be charged to the scheme or its investors.

Master-Feeder Structure

Currently, UCITS Directives limit the amount a UCITS may invest in another fund. UCITS IV will allow "feeder" funds to invest a minimum of 85% of assets in a "master" fund and the balance of a feeder's assets are subject to a prudent spread of risk requirement. H.M. Treasury and FSA think this explicit reiteration necessary despite the fact that the balance may only represent 15% of net assets. Master funds may not themselves be feeders nor hold units in other feeder UCITS. Master UCITS may restrict themselves to investment from feeders or may be open to public investment, and Home State regulators must approve a feeder fund's investment in a master UCITS. Note also that if the master and feeders use different auditors or depositaries, those service providers must have agreements in place to cover appropriate information sharing.

Alongside this relaxation, the Financial Secretary to HM Treasury announced in a speech on 22 November 2010 (with HM Treasury repeating the announcement in the December 2010 consultation document with the FSA), that the UK government intends to launch a new authorised fund regime for a tax transparent vehicle to facilitate the master-feeder fund structure in the UCITS IV Directive, thereby enabling the UK to compete with similar structures already available elsewhere in the EEA.[4] Consultation is scheduled to begin in June 2011 with a number of representatives from the funds industry. It is likely that the consultation will focus, *inter alia*, on a number of key technical issues relating to the master feeder structure such as the genuine diversity of ownership test and the application of the controlled foreign companies provisions to any new vehicle.

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[4] See "*HM Treasury/FSA Transposition of UCITS IV: Consultation Document*", December 2010, paragraph 9.2, with the speech by Financial Secretary to the Treasury, Mark Hoban, on 22 November 2010, being available at http://www.hm-treasury.gov.uk/speech_fst_221110.htm

Supervisory Cooperation

UCITS IV attempts to improve on existing UCITS Directive obligations on regulators to cooperate with each other through more detailed information sharing and supervisory cooperation provisions.

Conclusions

Consensus in relation to UCITS IV is generally of the welcoming kind. The Directive is seen as an undoubted enhancement to the UCITS industry (which has continued to grow despite the restrictions of predecessor Directives), offering flexibility, simplified regulatory processes, cost savings to the industry and, at the same time, investor protections. In addition, and in light of the small size of European funds relative to US retail funds, opportunities for mergers of UCITS can only proliferate under this legislation.

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Please feel free to contact any of the following attorneys if you have any questions about this memorandum.

Nick Shiren +44 (0) 20 7170 8778 nick.shiren@cwt.com
Adam Blakemore +44 (0) 20 7170 8607 adam.blakemore@cwt.com
Assia Damianova +44 (0) 20 7170 8564 assia.damianova@cwt.com
Alix Prentice +44 (0) 20 7170 8710 alix.prentice@cwt.com