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UCITS – PAST, PRESENT AND FUTURE
IN A WORLD OF INCREASING PRODUCT DIVERSITY



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in a World of Increasing Product Diversity**

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UCITS – PAST, PRESENT AND FUTURE IN A WORLD OF INCREASING PRODUCT DIVERSITY

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I. Introduction

This Paper will look at the changing nature of asset management, and will examine the nature of the European framework for collective investment undertakings, enshrined in the UCITS Directive² in that light. This question whether the UCITS Directive in its current form remains an appropriate European response to the changing investment management landscape is an issue with which the European Commission is actively engaging through its *Green Paper on the Enhancement of the EU Framework for Investment Funds*, published in July 2005.³ But before considering these important questions, it is necessary to begin with an idea of what a collective investment, more specifically a UCITS actually is and how it fits conceptually in the broader world of pooled investments.

II. The nature of pooled investment

A. The nature of “pooled investment”

This section of the Paper will refer to “pooled” investment, rather than “collective” investment. This subject is one that is heavily laden with terminological and definitional implications. The term “collective investment” has specific meanings, both in English Law, where the term “collective investment scheme” is a defined term,⁴ and also in European Law where the term “collective investment undertaking” is similarly a term with particular technical meaning. Both of these terms in fact seem to refer to open-ended investment

¹ Ashley Kovas writes in a personal capacity. The views expressed herein are those of the author, and do not necessarily reflect the views of the Financial Services Authority. This document does not constitute guidance for the purposes of section 157 of the Financial Services and Markets Act 2000.

² Council Directive 85/611/EEC of 20 December 1985, O.J. L375, 31.12.85, as amended (the “UCITS Directive”).

³ COM(2005) 314 final. A Feedback Statement was published on 13 February 2006 – available from the Europa website.

⁴ Financial Services and Markets Act 2000, section 235, as further explained in the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (SI 2001/1062).

vehicles.⁵ A “pooled investment” however, will be taken as one that is neutral as to its structure.⁶

So what is a “pooled investment” vehicle and in particular, how does it differ from other forms of capital raising by trading companies? In other words, how does a “pooled investment” differ from an oil company or a pharmaceuticals company? Both provide means by which investors can participate in the risks and returns of business activities for example the production of oil or pharmaceuticals. It seems however, that pooled investment vehicles form an intermediary bridge, where the investors collectively empower an asset manager to act on their behalf in the selection, acquisition and disposal of interests in business activities. Even this distinguishing characteristic is a fine one – there are some conglomerate groups of companies where the group holding company itself holds a series of underlying subsidiary companies.

However in the case of a conglomerate, the intention of the group management is not (usually at least) to manage the portfolio, by the frequent purchase and sale of group companies. Instead the arrangement is more static in nature. So perhaps management of assets is a usual feature of a “pooled investment”. Another important feature of “pooled investment” tends to be that of risk spreading or diversification.⁷

A “pooled investment” strategy can be operated in theory in any number of legal structures, provided the structure allows a group of participants to pool their money in a way that results in its common administration by a manager. In the UK, there are three important ways (important for the purposes of this paper at least) in which a “pooled investment” can be structured – as an investment company,⁸ as a life insurance contract,⁹ or as a collective

⁵ This is certainly the meaning of the term in UK law. See also the use of the term in Article 19(1)(e) of the UCITS Directive, and also the definition of “collective investment undertaking other than the closed-end type” at Article 2(o) of the Prospectus Directive (Directive 2003/71/EC). For details of the concept of “open-endedness”, see Section I.D of this paper.

⁶ In particular, whether it is open or closed ended.

⁷ In the UK, see the requirement for an “adequate spread of investment risk” in the FSA Listing Rules (at LR 15.2.2R(2)), and also the requirement for investment risk spreading for open-ended investment companies (Financial Services and Markets Act 2000, section 236(2)(a). For unit trusts, the requirement for a spread of risk is found in COLL 5.2.3R(1) (for UCITS schemes), 5.6.3R(1) (for non-UCITS retail schemes) and 8.2.6R for Qualified Investor Schemes.

⁸ See section 266 of the Companies Act, and the FSA’s Listing Rules, Chapter 15 – “Investment entities”.

⁹ See FSA Rules, IPRU, Rule 3.7.

investment scheme.¹⁰ The definition of “collective investment scheme” in particular, seems to be deliberately wide and all embracing in nature and is evidently aimed at classifying a whole range of potential structures that would otherwise remain uncategorised. Section 235 of the Financial Services and Markets Act 2000 defines a “collective investment scheme” as:

- “(1) ...any arrangement with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.
- (2) The arrangements must be such that the persons who are to participate (“participants”) do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.
- (3) The arrangements must also have either or both of the following characteristics –
 - (a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;
 - (b) the property is managed as a whole by or on behalf of the operator of the scheme.”

Some structures that might otherwise fall within the definition are however expressly excluded from the definition, for public policy reasons.¹¹

Importantly the definition embraces the “unit trust” structure and also structures based on partnership law. It also specifically includes open-ended investment companies, but not closed-ended ones.¹²

The categorisation of the investment structure provides the hook on which regulation is applied. So, in the UK, the legal and regulatory regimes for closed-ended companies,

¹⁰ Financial Services and Markets Act, section 235.

¹¹ See the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (SI 2001/1062).

¹² See section 236 of the Financial Services and Markets Act 2000.

regulated collective investment schemes¹³ and life insurance contracts are separate and different.

It would also be possible to classify a pension fund as an additional form of pooled investment. In the UK, pension funds are either of the occupational type, in which case they are outside the regulatory control of the FSA, or else they are personal pension products. Personal pension products are based on regulated collective investment schemes or life insurance products. The pension “wrapper” confers tax benefits for the benefit of the investor.

In the UK it is also possible to create what might be considered “quasi products”. For example, an investment manager could enter into discretionary investment management agreements with a series of customers on exactly the same terms as regards investment mandate. This would then enable the manager to manage the agreements as a whole. To avoid triggering the UK statutory definition of “collective investment scheme”, it would be necessary however for the clients’ property itself to remain segregated. Pooling the property for common management may well make the arrangement a “collective investment scheme”.¹⁴

B. The parallel development of collective investment schemes and investment companies in the UK

The first investment company to be established in the UK was what is now the Foreign and Colonial Investment Trust PLC, which was formed in 1868. Its objectives were “to give the investor of moderate means the same advantages as the large capitalists in diminishing the risk of spreading the investment over a number of stocks”. This company now claims to be the largest global growth investment trust in the world.

At the time of its invention, it seems that the investment company was treated for regulatory purposes in exactly the same way as any other company, and the modern approach is still essentially similar. Regarding investment companies to be akin to trading companies

¹³ There is a regime for unregulated collective investment schemes, but that deals only with the manner in which such schemes can be marketed (which is highly constrained – see FSA Rules COB Chapter 3, Annex 5) and the nature of the information to be disclosed to participants (see FSA Rules COB 10.6 and 10.7).

¹⁴ Financial Services and Markets Act 2000, section 235(3)(a).

suggests that the activity of investment can be regarded as simply one more strategy for making returns for shareholders.

Investment companies have, as companies, been subject to the rules of the London Stock Exchange, as any other company. The rules for admission to the Exchange provide some guarantee of quality of the investment proposition.

In 1936 a Report was made to Parliament on the growth of the “unit trust” movement that had taken place in the 1930s.¹⁵ Investors were flocking to place funds into open-ended unit trusts. The first trust appeared in 1931 and by 1936 there were 67 schemes available, with a total investment of £50 million. The Stock Exchange had expressed concern that unit trusts, which were offered to the public directly by their operators, were not being subjected to the same quality criteria that applied to listed investment companies.¹⁶

In 1939 the Prevention of Fraud (Investments) Act was enacted which applied an investor protection safeguard for unit trusts. This Act provided for the Board of Trade to approve unit trust schemes, and proscribed the public marketing of schemes other than authorised ones. So a parallel regime to the listing of investment companies was created. The power to approve unit trust schemes (and, on their introduction, open-ended investment companies) was devolved to the Securities and Investments Board under the Financial Services Act 1986. The power is now, of course, exercised by the FSA under powers set out in the Financial Services and Markets Act 2000.¹⁷

The Financial Services Act 1986 was a profound modernisation of financial regulation in the UK. Although investment management was indirectly regulated through the licensing provisions of the Prevention of Fraud (Investments) Act 1958, the collapse of the investment management firm Norton Warburg, and the investor losses that occurred, brought demands for additional regulation that was eventually provided with the Financial Services Act 1986.¹⁸ That Act has, of course, subsequently been superseded by the 2000 Act that established the FSA.

¹⁵ *Fixed Trusts – Report of the Departmental Committee Appointed by the Board of Trade, 1936* (Cmd. 5259)

¹⁶ *Report of the Stock Exchange Sub-Committee on Fixed Trusts (1935)*, reprinted in *The Economist*, 7 March 1936.

¹⁷ Section 242 *et seq.*

¹⁸ *Investor Protection* by A.C. Page and R.B. Ferguson, Chapter 15.

This leads to an interesting situation in UK regulation. The authorisation of collective investment schemes is the only example of product regulation in the UK. It arose at a time when the regulation of investment management as an activity would have been difficult to justify and in any event it seems that the concern which led to the 1939 Act was based, in part at least, on the problems associated with an absence of a listing requirement.

C. “Pooled investment” distinguished from discretionary asset management

“Pooled investment” products of the type described above, amount to investment products. These can be distinguished from investment services. Asset management is an investment service. So for example, a wealthy individual with several million pounds (or Euros) to invest could approach an authorised asset manager in the UK and ask for investment management services. Under such an arrangement, the assets entrusted to management by the customer are not pooled with the assets of other investors. Instead, the investment manager maintains a segregated portfolio for the customer. The customer enters into an individually tailored “discretionary investment management agreement” with the manager. This provides a great degree of flexibility in the relationship between the two parties. The customer is able to dictate to a fine degree (depending on his bargaining power) the terms of the investment mandate to be operated by the manager. In addition to wealthy private individuals, the asset manager may provide discretionary management services to other, institutional, investors. So, for example, the trustees of a UK occupational pension scheme could engage the services of an asset manager to manage the pension fund’s assets. But although the pension fund may have hundreds or even thousands of underlying contributors, the money invested with the asset manager is that of the pension fund – the pension fund is the client of the manager, not the underlying contributors to the pension fund. In a similar way, it is common in the UK for investment trusts (which are closed-ended companies in structure, rather than trusts) to engage the services of an external asset manager. Again, there may be thousands of shareholders of the investment trust, but the assets belong to the company. So the company becomes the client of the asset management for the provision of investment management services.

This suggests that investment products are generic in nature – the investor buys the product on the basis of what the product provides. Disclosure is key. In an investment

service, the investor has an opportunity to discuss what the specific service will amount to. Agreement is key.

D. Open-ended and closed-ended entities, and the importance of portfolio liquidity

An investment product may be open or closed-ended in nature. In a closed-ended product, an investor may sell his holding in the product through a secondary market, in which another investor buys the holding. In an open-ended arrangement, the investor redeems his investment by selling his participation back to the product provider. This important difference means that the operator of an open-ended structure needs to be able to meet foreseeable future redemptions. This means that some proportion of the product's assets need to be sufficiently liquid to enable cash to be raised in time to meet the product's redemption standard. In the UK, investment trust companies are (as are all companies) predominantly closed-ended in nature, whilst collective investment schemes are open-ended.

E. The purpose of pooled investment

Pooled investment vehicles are an integral part of the investment world. They are frequently used by institutional investors. For example, the investment managers of a pension fund may be perfectly competent to make individual stock selections for UK or European securities, but may lack expertise in the Japanese market. If the manager concludes that he should expose his fund to the Japanese market, he could of course deal with his lack of experience in a number of ways – he could employ a manager who understands the Japanese market, or he could enter into an agreement with another management company to provide an investment management service. It is also possible however, that he could simply purchase units in a pooled investment vehicle to provide the necessary exposure.

Pooled investment vehicles are particularly important in the world of retail investment. They form an important means for retail investors to gain exposure to equity markets. Two of the features offered by pooled investment vehicles – risk-spreading and management have already been mentioned. A third feature is, however, cost-effectiveness. Even if he has the necessary skill to decide on individual purchases of securities, a retail investor may well not have a sufficient amount to invest to make economic sense. The brokerage fees may eat

heavily into his capital. Pooled investment vehicles are likely to offer a more cost-effective means for retail investors to invest.

Having looked at the basic features offered by the products, it is important to consider how they are sold. In the UK there is an aphorism that financial services are “sold and not bought”, meaning that the provider needs to actively market his products. He cannot wait passively for consumers to come to him – even though the consumer may be badly in need of the products in question. When inviting retail investors to entrust them with relatively substantial amounts of their capital, product providers are incentivised to create a message of trust – that the investor can safely entrust the provider with such a sum of money. This message of trust is of course important in all areas of financial services. Unlike other consumer transactions, financial services are invisible. The consumer receives no tangible goods. All he receives is documentation and the hope that his affairs will be properly managed.

III. The UCITS Directive

A. Introduction

A proper understanding of the EU regime for “undertakings for collective investment in transferable securities” (“UCITS”) cannot be acquired in isolation from Member States’ own regulatory regimes for collective investments. The UCITS Directive itself sets out to deal with structures that were already in existence in the EU at the time of the Directive – collective investment undertakings can be structured in Member States as open-ended investment companies, unit trusts, or as contractually based schemes. All may in principle be UCITS.¹⁹ Although the Directive deals with aspects of the regulation of such schemes, particularly on investment powers, other matters are left to national law – for example, pricing methodology, corporate governance, frequency of redemptions by the manager.

It is also important to recognise at the outset that the UCITS Directive is concerned with the passporting of schemes. It provides that schemes which meet the requirements of the Directive should be allowed to be freely marketed in other States of the EEA, subject only

¹⁹ See Article 1(3) of the UCITS Directive.

to a notification requirement from the UCITS to the competent authorities of the host state.²⁰ The Directive does not preclude the existence of domestic funds that do not attract the passport.²¹ If such schemes are to be marketed in a host state in the EEA, it would be necessary for any applicable local regulations to be complied with. These may severely restrict the marketability of such products. In the UK, it is possible to market unregulated collective investment schemes only to narrow classes of person.²²

The Directive is notoriously opaque in a number of areas, and different interpretations have arisen in the EU, leading to some difficulties in the cross-border trade in UCITS. A key issue has been the interpretation of Article 19 of the Directive which establishes which instruments a UCITS is permitted to invest in.

Article 19 provides that a UCITS may invest in:

- Transferable securities and money market instruments, dealt on regulated markets in Member States or admitted to official listing in non-Member States, or those that have been recently issued where the intention is for the securities to be dealt in on regulated markets or admitted to official listing;²³
- Units of UCITS authorised according to the UCITS Directive;²⁴
- Other collective investment undertakings (i.e. those that are not authorised under the UCITS Directive) which themselves have the sole object of collective investment in transferable securities and/or in other liquid financial assets; and where the scheme is open-ended in nature;²⁵
- Deposits with credit institutions;²⁶

²⁰ See Article 46. Note that the host state has competence to apply local marketing law to incoming UCITS (Article 44).

²¹ In the UK, for example, the FSA authorises “non-UCITS retail schemes” (NURSSs), for marketing to retail investors, and “qualified investor schemes” (“QIS”) for marketing to predominantly sophisticated investors.

²² See section 238 of the Financial Services and Markets Act 2000, and FSA rule COB 3.11.1G and COB 3 Annex 5 for a list of the classes of person to whom such schemes are marketable.

²³ Article 19(1)(a) to (d).

²⁴ Article 19(1)(e).

²⁵ Article 19(1)(e), which incorporates Article 1(2).

²⁶ Article 19(1)(f).

- Financial derivative instruments, including both those dealt in on regulated markets and those dealt over-the-counter;²⁷
- Money market instruments, other than those dealt in on regulated markets.²⁸

Having established the classes of eligible assets, the Directive goes on to apply a series of highly detailed investment limits, which are set out in Articles 22 – 26. The purpose of these limits is undoubtedly to ensure that UCITS are diversified pools of investment. So for example, a UCITS may not invest more than 5% of its assets in transferable securities or money market instruments issued by the same body. A UCITS may not invest more than 20% of its assets in deposits with the same body. Limits of this kind are designed to prevent a UCITS from being unduly affected by any financial difficulties suffered by a company or bank into which it has invested/deposited its funds. Looking at diversification in another way, Article 25 provides that no investment company or unit trust may acquire more than 10% of the non-voting shares or debt securities of any single issuing body.

A UCITS is permitted to borrow up to 10% of its assets/value provided that the borrowing is on a temporary basis.²⁹

Article 37 of the Directive provides that a UCITS “must repurchase or redeem its units at the request of any unit-holder”, indicating that investors in UCITS must be given a facility for disinvesting. However, Article 37 does not apply a timeline for redemption, so the Directive is silent on how frequently redemption is to be offered, or how quickly funds should be remitted to a disinvestor, following disinvestment.³⁰

The Directive provides that any UCITS that wishes to market its units in a host state must inform the competent authorities of the host state in advance, and must, in support of the notification, send various information to the host state authorities.³¹

²⁷ Article 19(1)(g).

²⁸ Article 19(1)(h)

²⁹ Article 36(1) and (2).

³⁰ Article 34 however requires the publication of prices at least twice per month, and the FSA has adopted that standard in its regime for UCITS. UK UCITS must therefore offer units for sale and redemption twice per month, and those points must be at least two weeks apart – see COLL 6.3.4R(1).

³¹ Article 46.

Although the Directive provides for cross-border marketability of UCITS, host Member States are given authority to apply local marketing provisions, though any such local provisions “must be applied without discrimination”.³² Where a UCITS in fact does market its units in a host state, it “must take the necessary measures to ensure that there are facilities in the that State for making payments to unit-holders, repurchasing or redeeming units and making available the information which UCITS are obliged to provide”.³³

The Directive provides informational requirements for UCITS to give to investors – which take the form of full and simplified prospectuses. In addition, UCITS are required to produce annual and half-yearly reports for investors.³⁴

B. UCITS III

The UCITS Directive was originally enacted in 1985 and the text of that initial Directive has become known as “UCITS I”. In 2001, two amending Directives, collectively known as “UCITS III,” were enacted which changed the nature of UCITS quite substantially.³⁵ The so-called “management company Directive”³⁶ concerned itself with the nature of the activities which a UCITS management company (which is a company separate from the UCITS itself) can undertake, and applied a passport to the management company for the first time (prior to this amendment, only the UCITS itself was given a passport).

The “product directive”³⁷ made significant changes to the investment powers of UCITS – those powers, as amended, have already been set out above. The amendment allows UCITS to invest in a much wider range of investments, including:

- Other collective investment schemes, enabling the possibility of a UCITS fund of funds;

³² Article 44.

³³ Article 45.

³⁴ Article 27.

³⁵ "UCITS II" refers to a UCITS reform in the 1990s which was never implemented. Some commentators have suggested that the "management company directive" was UCITS II with the "product directive" as UCITS III. However, it seems that European Commission takes the view expressed in this paper. The European Commission's view must, of course, be taken as conclusive!

³⁶ Directive 2001/107/EC.

³⁷ Directive 2001/108/EC.

- Bank deposits and cash instruments;
- Money market instruments;
- Financial derivative instruments;
- Index tracker funds

The last three of these has given rise to concerns in some Member States about the changing nature of UCITS, and whether they remain appropriate for retail investors – or perhaps, more pertinently, whether retail investors understand the changes that are taking place. UCITS funds operate at the core of the retail investment funds regimes of Member States. Indeed, some non-EU countries have established arrangements that allow UCITS funds privileged access to their own retail investment market, indicating that the “UCITS brand” has an established safety and security about it.

C. CCSR work on “Eligible Assets”

In 2004, the European Commission published a Mandate for the Committee of European Securities Regulators (CESR).³⁸ The Mandate was issued under Article 53(a) of the UCITS Directive, which empowers CESR to act as an advisory committee³⁹ to the Commission on:

- Clarification of the definitions in order to ensure uniform application of the Directive throughout the EU;
- Alignment of terminology and the framing of definitions in accordance with subsequent acts on UCITS and related matters.

The Mandate asked CESR for advice on:

- The definition of “transferable securities” (Article 1(8) of the Directive)
- The definition of “money market instruments” (Article 1(9))
- “Other collective investment schemes” (Article 19(1)(e))
- “Financial derivative instruments” (Article 19(1)(g))
- Index replicating UCITS (Article 22(a)(1))

³⁸ “Formal mandate to CESR for advice on possible modifications to the UCITS Directive in the form of clarifications of definitions concerning eligible assets for investment of UCITS”, Document reference CESR/04-586, 28th October 2004, available from the CESR website, www.cesr-eu.org.

³⁹ See the reference in Article 53(a) to Council Decision 1999/468/EC which is part of the Lamfalussy process, which has streamlined the process EU financial services lawmaking. The process, by which the Commission is enabled to take actions under existing EU law, with assistance of a committee, is known as “comitology”.

The exercise generated two interim Consultation documents,⁴⁰ and the Final Advice to the Commission was published on 26th January 2006. The Advice amounts to a lengthy document at 66 pages. The analysis which follows in this Paper amounts therefore to “headline” points, rather than a full analysis of a complex document.

Now that the Advice has been published, the European Commission will need to create a legal instrument based on it – this is not expected to be in force until Autumn 2006. The Commission could issue a Regulation, Directive, Recommendation or Opinion. One of the first two are perhaps more likely, and there seems to be some suggestion that a Regulation will be the preferred instrument.

Transferable securities

The CESR Advice clarifies the qualities that a “transferable security” should meet in order to be eligible. In effect, this amounts to a definition of Article 1(8) of the Directive which provides that a “transferable security” comprises: company shares (and securities equivalent to shares), bonds and other debt securities, and any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange.

The Advice clarifies various matters, including that the liquidity of a security must not compromise a UCITS’ ability to meet foreseeable redemptions. This is a matter of Article 37 of the Directive, which states that “a UCITS must re-purchase or redeem its units at the request of any unit-holder”. In addition, for a listed security, accurate, reliable and regular prices must be available, and there must be regular, accurate and comprehensive information available to the market on the security.

The treatment of closed-end funds (including, in the UK context, investment trust companies) was also addressed. Early discussions showed significantly different approaches on this across the EU, with some Member States arguing that the eligibility of such funds should be assessed under Article 19(1)(e), which has always been taken by UK regulators to refer only to open-ended structures. CESR has now resolved that closed-end funds are eligible assets (where structured as transferable securities) if they themselves meet certain

⁴⁰ 18 March and 20 October 2005, both papers are available on the CESR website.

criteria. Importantly, where asset management activity is outsourced by the closed-end fund, the CESR Advice clarifies that it must be done by a firm that is itself subject to national regulation for the purposes of investor protection. This clarifies that UK investment trusts are eligible assets for UCITS.

CESR also advised on the circumstances under which a transferable security (or indeed a money market instrument) should be regarded as embedding a derivative. Article 21(3) states that where such an instrument embeds a derivative, "...the latter must be taken into account when complying with the requirements of this Article". This opens embedded derivatives to the risk management process provided by Article 21. CESR has drawn on the work of IAS 39 in determining that an embedded derivative amounts to a contract held within a non-derivative host contract, "with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative". Whether any specific instrument does in fact embed a derivative will of course need to be decided on a case-by-case basis using the CESR criteria.

Money market instruments

A highlight in this part of the paper has been the acceptance in principle of amortised price methodology for the pricing of money market funds, subject of course to criteria designed to ensure that the price does not diverge materially from the fund's net asset value.⁴¹ Some Member States were initially concerned that there should be any permitted divergence of the price of a UCITS from its net asset value.

Other collective investment schemes

This part of the work proved less contentious than others. The Advice sets out various criteria that competent authorities can use in assessing whether a non-EEA collective investment undertaking is subject to the necessary supervision and regulation, as required by Article 19(1)(e).

⁴¹ Net asset value (NAV) is, in principle, the value of the assets of the UCITS divided by the number of units in issue.

Financial derivative instruments

The issue here was to devise generic factors to apply to financial derivative instruments (FDIs) to mark their eligibility for UCITS. CESR did not set out to devise a prescriptive list of eligible instruments.

The Advice clarifies that FDIs based on various assets are themselves to be considered eligible, but also clarifies that derivatives based on non-financial indices or commodities are ineligible.

CESR has decided that the issues raised by hedge fund indices means that FDIs based on them should not be construed as eligible at this time. However, CESR has promised to revisit the issue within one year, starting from October 2005.

Index replicating UCITS

This part of the paper was less controversial than many others. Original CESR thinking, expressed in the first eligible assets consultation⁴² about the imposition of a prescribed measure for the “quality of replication” (i.e. tracking error) was later dropped from the text.

IV. The changing nature of asset management

A. Wider-range retail investment products – the FSA’s June 2005 Discussion Paper

The nature of retail investment products appears to be changing across the board – this is not a matter limited to UCITS, but it certainly includes the development of UCITS III products. It has been suggested above in Section II that retail investment products have historically offered features of management and risk spreading. Although the growth of techniques linked to derivatives has grown somewhat over the years, the classic way in which risk spreading has been achieved has involved the manager holding a series of underlying investments within the portfolio. Some of those investments may flourish; others may fail completely and go out of business. But across the portfolio, the effect (positive or negative)

⁴² March 2005.

of any individual underlying investment is linked to the degree of exposure taken to that particular investment.

Another effect of the simple investment proposition outlined above is that investors in the retail investment product tend to get a return that is significantly market risk related. The value of the investment product will rise or fall broadly in line with the market. In other words, the portfolio of such a product has a significant level of “beta”.⁴³

Many of the retail investment products that are now being produced seek to minimise market risk in some way – in other words there is a shift of approach from beta to alpha. This is perhaps unsurprising. Many retail investors lost money in the recent “bear” market. Investors in technology funds may in particular have lost quite significant sums as a result of the bursting of the “technology bubble”. This experience has led retail investors to be averse to market risk. So, in an effort to provide appropriate investment propositions, product providers have concentrated on minimising market risk wherever possible, for example through the use of guaranteed structured products. Various types of hedge fund strategy might also minimise market risk more subtly through the hedge fund techniques of short-selling, derivatives and leverage. This is all very well, but it leads to a legitimate regulatory concern that retail investors may not understand the true nature of the new-style or “wider range” products.

An interesting but important fact, however, is that it seems most retail investors were fully aware of the nature of the market risk they were running. It is true that there are always complaints from the retail sector that the basic risks have not been properly explained. During the bear market, however, there does not seem to have been a significant increase in such complaints, suggesting that the link between the value of a pooled investment vehicle and its “market” is widely understood.⁴⁴

⁴³ “Beta” is a reference to the return on a market – so a portfolio with a beta of 1 has a return equivalent to that of the market. “Alpha” is a reference to a return unrelated to that of the market. It is normally attributed to the skill of the investment manager.

⁴⁴ The author points out that this is a subjective impression. He is not aware of any research conducted to prove the point one way or the other.

The FSA aired concerns about wider range retail investment products in a Discussion Paper published in June 2005 and entitled *Wider-range retail investment products: Consumer protection in a rapidly changing world*.⁴⁵

The Discussion Paper states that there are risks of three kinds emerging from the increasing novelty and diversity of retail investment products:⁴⁶

- (1) There is a risk of consumer mis-understanding;
- (2) There is a risk of potential mis-buying or mis-selling;
- (3) There is a risk that different regulatory approaches applied to different product structures might suggest that consumers do not have sufficient access to appropriate products.

Points (1) and (2) are relatively easy to extrapolate from the concerns expressed above. Point (3) requires a little more elaboration. The Discussion Paper points out that, as explained above, there are a number of different ways in which retail investment products can be structured in the UK – investment companies and collective investment schemes to name but two. The different regulatory regimes applied to the different structures means that there are differences in the investment strategies that can be run within them. The UK regime for authorised collective investment schemes⁴⁷ does not, however, provide much opportunity for exposure to alternative investments. This may be a perverse outcome, given that the authorised schemes regime is highly regulated. In particular, it contains a requirement for a separation of the functions of “manager” and “depository”. The manager is responsible, in effect, for operating the scheme. The depository is responsible for safeguarding the assets of the scheme and, to some extent, for supervising the activities of the manager. The strength of the regulatory regime suggests that it may be possible to allow for some wider range strategies to form part of the “non-UCITS retail schemes” regime.

So, intriguingly, (1) and (2) point in an opposite direction to (3). So, if the FSA were satisfied that consumers understood sufficiently well the nature of “wider range” retail investment products, and if we could be satisfied that mis-selling or mis-buying of such

⁴⁵ Discussion Paper 05/3, available from the FSA website, www.fsa.gov.uk.

⁴⁶ See Discussion Paper 05/3, pages 9 and 10.

⁴⁷ The regime for authorised retail schemes is divided into two types of scheme: there are separate regulatory regimes for “UCITS” schemes and for “non-UCITS retail schemes” (NURs). NURs are schemes which do not comply with the UCITS Directive, but which the FSA is content may be marketed to retail investors.

products could be minimised, it may be desirable to allow for greater access to such investment strategies through the authorised collective investment schemes regime.

It may be useful to touch briefly on what consumer understanding actually means. It is probably not generally necessary for retail investors to understand the full technical detail of the operation of retail investment products. Instead the consumer needs to understand how to *use* the products – in much the same way that the driver of a car does not need to be able to explain the operation of the internal combustion engine in order to drive to the shops. It is useful therefore to ask in what way wider-range products should be used, in distinction to more traditional offerings. It may be, for example, that retail investors should not invest disproportionately in wider range products. The idea that investors should not “put all of their eggs in one basket” is, of course, an investment principle in its own right, even in respect of older style investment products. The principle may, however, have a greater importance where the product in question is a wider range one. In a world of novel investment propositions, retail investors need to understand how to operate a portfolio of investment products, which may require switching between products as economic conditions and other factors change – in other words, they need to manage their portfolio actively. In many cases, product providers have tended to promote their retail investment products as long-term in nature. Indeed, providers have tended to promote investment products as a form of commoditised investment *service* – see the distinction drawn in Section II.B between an investment product and a service (under a discretionary asset management agreement).

The Discussion Paper asked whether wider range products could in some sensible way be distinguished from non-wider-range products, using measures of volatility, illiquidity and/or complexity as means to define “wider range”. It would of course be equally feasible, perhaps more so, to seek to define the non-wider-range products. The key question here, though, is whether such a distinction could be done in a way that proves meaningful to investors.

The Discussion period for DP05/3 closed at the end of October 2005 and on 23 March 2006, the FSA published Feedback Statement 06/3 (FS06/3), providing the feedback from the discussion launched in DP05/3, and proposing a way forward. The FSA’s conclusion was that the segregation of products into “wider range” and “non-wider range” was not a sensible proposal, and that idea has been dropped. It would possibly cause investors to attach too

great a safety to the “non-wider range” products, with too great a danger to the “wider range” ones. It is quite possible that a proportionate investment in a “wider range” product may be appropriate for some retail investors.

Having eliminated the idea of product segregation, the FSA makes three proposals. First, the increasing variety of retail investment products is something that consumers should know about. Specifically, they should understand how to use products safely, as outlined above.

Second, the FSA proposes to look at the issue of “product provider responsibility”. This refers to the relationship between the provider and intermediary. In the UK, investment products are commonly distributed by persons other than the manufacturer. Yet, in cases where a product is innovative or possibly unique, the asymmetry of information between provider and distributing financial adviser may be very significant. The FSA proposes to look at the relationship between the provider and distributor, to see whether the provider should bear more responsibility than he does at present for the manner in which his products are brought to investors.

Third, the FSA has proposed allowing for retail “funds of unregulated schemes” in the authorised collective investment schemes world.⁴⁸ This would allow for the authorisation of funds of hedge funds, among other things.

The FSA will consult further on this issue in the first quarter of 2007. However, it seems certain that the issues raised will provoke much discussion before then.

The fundamental issues with which DP05/3 is concerned are reflected in other literature. In March 2005, UBS published *The critique of pure alpha*, a research piece by Alexander Ineichen. Mr Ineichen suggests that the asset management industry is undergoing a period of structural change, driven by the fact that investors generally are waking up to the fact that the short-term volatility of portfolios is more important than many had thought previously – or in other words “this means that investors are migrating to the belief that time

⁴⁸ The underlyings of such a fund of funds would include both collective investment schemes, and investment companies.

does not reduce risk”.⁴⁹ Indeed, he points out that “The problem with large drawdowns is that they kill the rate at which capital compounds”.⁵⁰ So Mr Ineichen’s argument is that investors should be, as a matter of logic, searching for the absolute returns potentially offered by alternative investments, rather than the relative returns offered by more traditional asset management. The FSA’s argument in DP05/3 and FS06/3 is that investors need to understand to some extent the nature of the different risks that they run in wider-range products – in deciding how to manage a portfolio of investment products.

B. The European Commission’s Green Paper

Shortly after the publication of the FSA’s Discussion Paper, the European Commission published its *Green Paper on the Enhancement of the EU Framework for Investment Funds*.⁵¹ The Commission recognises that “New fund-types, based on more sophisticated investment strategies, may embody features that are not well-understood by retail investors”.⁵² It also recognises that “investors faced with more complex products need better and user-friendly disclosure of performance and charges.”⁵³ There is reference to the potential use of the Markets in Financial Instruments Directive (MiFID) to provide a “useful “toolbox”, notably to clarify all duties of care, risk warnings or other obligations that an investment firm owes to a client considering an investment in UCITS”⁵⁴ – in recognition of the fact that UCITS III products are potentially very unlike the products that retail investors are used to.

The Green Paper takes a fairly fundamental look at the UCITS Directive and the nature of UCITS themselves, and suggests various ways in which the Directive could be made to work better. It recognises the key work being done by CESR on the definition of eligible assets, among other things. It also recognises that “with its reliance on formal investment limits, UCITS may struggle in the longer term to keep pace with financial innovation and more complex distribution systems.” There is a hint here that the UCITS Directive may not easily be able to cope, in its present form, with the likely changes in investment strategy.

⁴⁹ *The critique of pure alpha*, page 10.

⁵⁰ *Ibid.*

⁵¹ COM(2005) 314 final, published 12 July 2005.

⁵² *Ibid.*, page 3.

⁵³ *Ibid.*, page 5.

⁵⁴ *Ibid.*, page 6.

The Green Paper suggests that, despite its flaws, the time is not yet right for a wholesale redrafting of the Directive. Any such redrafting would need to reflect fully the Lamfalussy process – the Directive would need to be cast as a framework text, with much of the detail coming from Level 2 material – that material would need to be constructed based on advice from CESR.

V. *Caveat emptor*

At this point, it may be useful to draw out another aspect of the debate on changing products – the nature of the respective responsibilities of product providers and the retail investors to whom they market their products.

The Financial Services and Markets Act 2000 is the Act which establishes the FSA and provides it with its statutory powers. It sets a series of “statutory objectives” for the FSA to fulfil. One of those is “the protection of consumers”.⁵⁵ The Act defines this objective as “securing the appropriate degree of protection for consumers”.⁵⁶ In deciding what level of protection is appropriate, the FSA is required to have regard to a number of factors:

- (a) the differing degree of risk involved in different kinds of investment or other transaction;
- (b) the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity;
- (c) the needs that consumers may have for advice and accurate information; and
- (d) the general principle that consumers should take responsibility for their decisions.

These various matters require a balance to be drawn – item (d) is of course an important balancing factor, recognising that the FSA is not able to protect retail investors against the consequences of their own financial foolishness.

⁵⁵ Section 2.

⁵⁶ Section 5.

FSA Chairman, Sir Callum McCarthy gave a speech on 9 February entitled *What does caveat emptor mean in the retail market for financial services?*⁵⁷ in which he expanded on what the regulatory balance means in practice. Sir Callum said:

“I am uneasy about the FSA, or any other regulator, decreeing that a particular product should not be sold to the retail market... The FSA is not and cannot be in the game of assessing, *ex ante*, all products for risk, return and suitability, and I have reservations about those occasions when we do so. I do see more of a case for helping firms identify the particular risks they should consider when assessing suitability, or should describe to prospective customers”.

VI. Conclusions

The trend towards increasing diversity and novelty of retail investment products is unlikely to cease. There are a number of potential structures in which products can be manufactured for retail investors – the collective investment scheme, and specifically UCITS, is only one of several such vehicles. The increasing novelty of products affects all product structures. The key concern with this development lies in consumer understanding. If we were happy that consumers’ understanding of the new-style products were sufficient, we would not have any great difficulty with their sale.

Earlier in the paper it was suggested that retail investors might have some familiarity with market risk – the idea that the value of a pooled investment vehicle can rise and fall in line with the market.⁵⁸ This is not proved by any research, but rather seems intuitive from the absence of substantial retail complaints during the bursting of the “technology bubble” and the bear market generally.

The key difference between older-style investment products and the new ones (including the products now being offered within the UCITS Directive) seems to be the changes to the “market risk” profile of the product, i.e. the shift from beta to alpha. Products that do this have been around for some time – for example, market neutral hedge funds. However, their perceived need in the retail sector has arisen because retail investors have themselves concluded that market risk is not a good thing to bear. They have become risk

⁵⁷ A speech to the Financial Services Forum, available on the FSA website: www.fsa.gov.uk.

⁵⁸ That is, with the market to which the product is benchmarked.

averse as a result, and are now sceptical about investment products. This implies that the bond of trust, which is essential in the sale of financial services has been damaged.

The problem with understanding relates to the fact that retail investors may understand that the new-style products minimise the extent of market risk, but may not understand that there may be other risks added as a consequence. Put another way, risk and return remain as correlated in the new-style investment products as they always have been. If the product continues to offer a return above the risk-free rate even after the market risk has been eliminated, there must be other risks within the product to justify the return.

Consumer understanding does not require that the retail investor understands in detail the way that the product operates. Instead, the retail investor needs to understand how to *use* the product. In practical terms the changing nature of products may mean principally that the retail investor should invest proportionately in such products. There is a tension here with the idea of “trust” – the product provider has an incentive to promote himself as a trustworthy home for a substantial part of the investor’s capital. The message that consumers should not “put all of their eggs in one basket” is however a sound one even as regards old-style products. However, the message may have even greater relevance for the newer products. After all, few people would advocate that any investor, retail or otherwise, should put all of his capital into one hedge fund. This idea that the retail sector is more responsible for its financial well-being is mirrored in other areas also – in the UK the closure of “defined benefits” pension schemes in favour of “defined contributions” arrangements is another example.

There are various potential methods that might be used to deal with the problem of consumer understanding. Perhaps the simplest would be to make the potentially misunderstood products disappear from the retail sector altogether. There would seem to be little chance of achieving that position. Indeed, it may be unwise to try. If Alexander Ineichen is right we are witnessing a fundamental change in the way in which asset management is conducted. It may not be wise to try to deny the retail sector the benefits of modern (or perhaps post-modern) investment thinking. During the depths of the bear market, the hedge fund industry suggested that investor protection was not met by consigning all retail investors to the falling market. Some have seen in the present situation something of an inequity –

with wealthy investors allowed access to alternative investment strategies, which are denied to the mainstream.

The idea that retail consumers are generally becoming more responsible for their own financial well-being in a world where investment products are becoming increasingly diverse has ramifications for the idea of *caveat emptor*, or put another way, on the nature of the regulatory protections that consumers can expect.

The starting point for the UK discussion on this topic has been the idea that the market for retail investment products could somehow be segmented to provide an intuitive sign-posting for retail investors to be able to judge the type of product that they might be considering. That idea has now been dropped in the FSA's Feedback Statement 06/3, published in March 2006. Instead, the FSA will focus on consumer awareness, and on the responsibility of product providers for distribution. In addition, the FSA proposes introducing a new range of retail collective investment schemes where the manager will be able to invest the fund completely into unregulated schemes.

It is suggested that the changing nature of retail investment products, and how to deal with it, is a key priority for the regulatory protection of the retail sector. However, other work is underway which is aimed at making the existing UCITS regime work properly. Much of this work is being done in the CESR Expert Group on Investment Management. The recent European Commission Green Paper on Investment Funds suggests that the CESR work should be given an opportunity to produce appropriate solutions before reaching for a more intensive European regulatory solution (a new Directive would be required). This seems to the FSA and the author to be the appropriate way to proceed. However, it seems fairly certain that, in the forthcoming few years, change will be the only certainty.

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