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Reaping the Rewards of UCITS Pooling

With Europe's asset management industry facing significant cost pressures, the introduction of master-feeder pooling as part of the UCITS IV directive gives asset managers a simple and cost-effective option for streamlining fund ranges and adding new funds to established structures. Moreover, master-feeders are likely to spark further interest in the concept of pooling, and asset managers will be weighing up the various types of pooling available.

The pooling of UCITS assets across national borders represents a holy grail for European asset managers, as it would give them greater scale when marketing throughout the European Union. While the latest version of the Undertakings for Collective Investments in Transferable Securities (UCITS) framework — UCITS IV — stops short of allowing full cross-border pooling, the introduction of a simple master-feeder structure is an important step forward.

Stemming from the pre-crisis focus on market efficiency, the master-feeder is one of several measures in UCITS IV designed to build greater scale in Europe's €13.5 trillion funds market.[1] Analysis by the European Commission (EC) and others found that European funds were, on average, five times smaller than US funds and the cost of managing them twice as high. Further, this research discovered that 54 percent of UCITS funds had assets of less than €50 million, meaning that many funds have insufficient scale to justify their costs.[2]

In another push toward greater market efficiency, UCITS IV clarifies the rules for cross-border mergers between UCITS funds, with the aim of driving consolidation of fund ranges. While fund mergers offer greater potential cost savings than master-feeders — given that they result in a single entity — the practical obstacles that exist to fund mergers, including taxation, may result in limited take-up in the short to medium term. By contrast, the attractiveness of master-feeders — and their potential for adding distribution channels and enhancing marketing flexibility — means they are likely to be used widely over time.

[1] European Fund and Asset Management Association, as at December 2010

[2] "White Paper on Enhancing the Single Market Framework for Investment Funds", Commission of the European Committees, 15 November 2006

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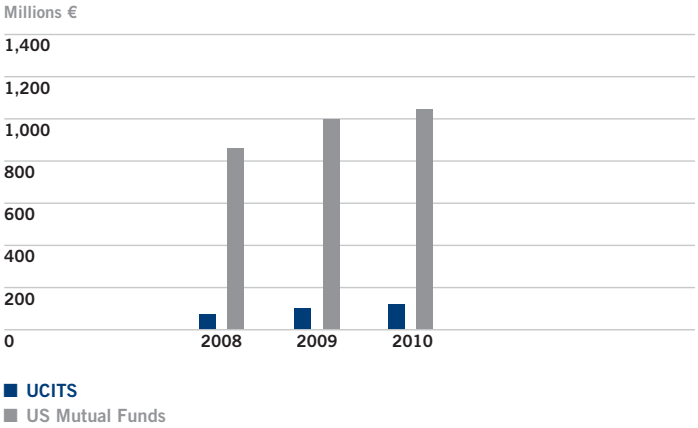
Figure 1: Average Fund Sizes, UCITS vs. US Mutual Funds



Source: EFAMA and ICI, exchange rates as of year-end periods

Pooling vehicles contrasted

Pooling has gained momentum in the past few years, as investors and asset managers have sought to increase the cost efficiency and transparency of their portfolios. The introduction of master-feeders is likely to fuel further interest. When considering the potential of the master-feeder — a type of entity pooling — asset managers should examine it against the other forms of pooling available. For managers who want to streamline their UCITS fund ranges across several European countries, the master-feeder may be an effective option. Alternative forms of pooling exist, however, that may be effective in specific circumstances, depending on a) the goals of the asset manager and b) the requirements of the end investor.

The two main existing types of pooling are virtual pooling and "tax-transparent" asset pooling:

- VIRTUAL POOLING — THE "TECHNOLOGY CLOAK" Virtual pooling can be an effective alternative to master-feeders, although currently it is normally only undertaken within a single jurisdiction. Virtual pooling involves wrapping a "cloak" of technology — a custodial and accounting infrastructure — around existing pools of assets allowing them to be managed and reported as if they were a single pool while remaining separate from a tax and legal perspective. Virtual pooling can be a useful tool for asset managers that want to streamline their fund structures within a single country. For example, a manager could domicile a series of similar funds in one market, bring them into a virtual pool to reduce cost and complexity, and then sell the funds into different geographic markets.

  Beyond a handful of jurisdictions, virtual pooling is currently difficult cross-border, and unsuitable for certain asset classes, due to variations in national regulations and accounting standards. Yet as securities markets evolve, virtual pooling may become a viable — and potentially more valuable — alternative to master-feeders. In the meantime, there is significant growth potential for virtual pooling within single markets, given the relatively limited take-up so far.

- ASSET POOLING WITH TAX TRANSPARENCY — THE INSTITUTIONAL VEHICLE Like the master-feeder, tax-transparent asset pooling is a type of entity pooling. Commonly seen in Europe, it involves several institutional investors commingling their assets into a single pool to achieve economies of scale. For institutional investors, this form of entity pooling has tax advantages. Investors are treated as if they are holding individual securities rather than units in an investment vehicle. Consequently, they do not lose any withholding tax benefits associated with their country of domicile — hence the "tax-transparent" label.

  Future growth in this type of pooling is likely to be driven in large part by demand from institutional investors for tax-efficient vehicles, particularly as initiatives such as the US Foreign Account Tax Compliance Act (FATCA) place additional emphasis on transparency of holdings.

Different master-feeder models

Generally speaking, the master-feeder is the vehicle most suited to introducing efficiency to European asset managers' fund ranges purely because it is designed to operate cross-border, encompassing multiple jurisdictions. As defined by the UCITS IV directive, a UCITS master fund invests the assets of one or more feeder funds. Feeder funds must hold at least 85 percent of their assets in the master fund, but can keep up to 15 percent in ancillary assets, including derivatives for hedging purposes. Although there must always be at least one UCITS feeder, not all feeder funds have to be UCITS funds. Non-UCITS funds such as UK OEICs can also feed into UCITS masters.

Master-feeders offer significant potential for asset managers seeking to optimise their cross-border UCITS fund structures. Many large asset managers run funds with similar investment strategies in different geographic markets, in some cases because these funds have been set up for specific institutional clients. The master-feeder provides a vehicle for pooling all the assets in a single master fund to gain economies of scale while keeping the feeder funds in place for marketing and other purposes. Once pools of assets start to grow in size, the benefits in terms of economies of scale and reduced costs are quickly realised.

Figure 2: Factors to Consider when Setting up a Master-feeder

While only a small number of asset managers are likely to establish master-feeders immediately following the introduction of UCITS IV, many asset managers are reviewing the practicality and benefits of these vehicles and taking a fresh look at the current architecture of their fund ranges. Once they have established the business case, they are likely to set up these pooling structures over time.

When considering setting up a master-feeder, asset managers need to analyse a range of factors:

- What are the tax implications for the investors and the fund?
- What is the legal process for transferring securities from feeder to master?
- What are the key regulatory considerations for the master and are there any special local restrictions to consider?
- What are the implications of the master and feeder funds' different reporting calendars, pricing times, accounting standards, look-through requirements and service providers?
- What are the marketing implications? How is the master-feeder structure viewed in the markets where feeders will be sold? Are remaining barriers such as the blocking of UCITS fund-of-fund investors into the feeder an issue?

Only when the multiple ramifications of establishing a master-feeder have been identified can a cost-benefit analysis be performed and a decision taken. With increasing cost pressures on the industry — and the associated focus on scalability and new distribution channels — it seems inevitable that master-feeder funds will become popular over time.

Asset managers now looking to establish master-feeder funds are considering several different models. In all cases, they tend to stipulate that they will only launch a master-feeder fund structure if the combination has only marginally higher administrative costs than the master fund alone. If that is not the case, they take the view that establishing these UCITS-specific asset pools would not be cost effective. Below are some of the approaches that asset managers are commonly considering.

- TRANSFORMING EXISTING FUNDS INTO FEEDER FUNDS Asset managers with existing UCITS in various jurisdictions may decide to use UCITS pooling as a cost-effective way of converting those funds into feeder funds. In this model, assets are pooled with those of an existing or newly created master fund to gain operational and management efficiencies.
- GLOBAL DISTRIBUTION Asset managers are also considering the global distribution model. In this instance, the asset manager uses UCITS pooling to facilitate global distribution. If, for example, the manager wants to distribute a strategy currently represented by a fund in a country that is not suited to international distribution, then this fund could be used as a master. A feeder could then be established in a domicile more suited to international distribution and distributed in Asia, the Middle East or Latin America.
- LOCAL COUNTRY MARKETING Finally, managers are considering setting up master-feeders to gain the flexibility needed to market locally in some European countries. For example, in the UK, fund supermarkets distribute a large proportion of investment funds and have historically preferred to market UK-authorised funds (although this situation is changing). Similar marketing sensitivities exist in other national markets. A master-feeder allows asset managers the flexibility of having a master fund outside the UK but a locally authorised fund to market within a country. Moreover, not all feeder funds have to be UCITS vehicles.

Maximising the cost benefits

Whatever the chosen approach to pooling, having a single service provider with proven capabilities across all relevant jurisdictions can alleviate complexity and help maximise efficiency savings. Asset managers seeking to establish a master-feeder network across Europe may find that a single service provider with an established pan-European presence and single IT platform can help them reap the full rewards of UCITS pooling.

Having a single, pan-European administrator may also avoid the complexity and cost of delegating administration. Furthermore, a pan-European depositary enables the master-feeder to have a single provider of depositary services across the master and the various feeders. Minimising the number of service providers in this way greatly improves operational oversight and enables coordination of local connections with regulators.

Similarly, having a service provider with a single IT platform simplifies the task of running master-feeders. As the UCITS IV directive will lead to more complex reporting, a single platform provides the important advantages of standardised reporting and consistent data — with no need to pass data between systems — and supports a consolidated approach in areas such as board reporting and cross-border distribution. Other types of pooling also benefit from an administrator with an advanced IT platform. Virtual pooling, for example, requires an advanced technological platform with custody, accounting and reporting capabilities across different legal entities and a variety of asset classes.

The future of pooling

At a time when asset managers face significant cost pressures, and are looking to capitalise on new markets and distribution channels, master-feeders are likely to gain in popularity. They are likely to be deployed gradually, on a case-by-case basis, in particular as a relatively straightforward way for asset managers to add new funds to established structures.

The master-feeder is set to spark greater interest in the whole concept of pooling, and the same crusade for efficiency may lead to more entity and virtual pooling structures being established. Growth in tax-transparent pooling is set to be driven by increased institutional investor insistence on tax-transparent vehicles. And while asset managers have only just started to explore the benefits of virtual pooling within a single market, this type of pooling has significant potential and will truly come into its own when changes in securities markets allow it to be extended cross-border.

In summary, pooling is set for a bright future. The holy grail of full, cross-border UCITS pooling may yet be out of reach, but asset managers have a number of options available to them. Evaluating these options carefully and partnering with experienced and expert service providers are key to success.

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