

UCITS III – Questions & Answers (Hong Kong Investment Funds Association)

(The following only aim to provide general background information; and cannot be construed as professional advice. You should consult your distributor and/or fund house to obtain detailed information on the funds you have invested in or are interested in; and seek their advice on UCITS III and other fund-related issues before making any investment decisions.)

1. *What does UCITS stand for? What is the difference between UCITS I, II and III?*

UCITS stands for the Undertakings for Collective Investment in Transferable Securities.

The first UCITS Directive (“UCITS I”) was adopted in 1985 to implement a single regulatory regime across the European Union (“EU”) for open-ended funds to invest in transferable securities. When a UCITS is authorized by a member state of the EU in which it is situated, such authorization is valid for all member states and no further authorization will be required if the UCITS is marketed in other member states.

However, individual marketing rules in each EU member state and the limited definition of permitted investments for UCITS I had weakened the marketing possibilities of a UCITS. In the early 1990's, proposals were developed to amend the 1985 Directive - leading to the draft UCITS II directive, but were subsequently abandoned as no common approach was adopted.

In 1998, the European Commission published a new proposal to amend the 1985 Directive. These proposals were finally adopted in December 2001 and are generally referred to as UCITS III. **UCITS III** consists of the following two directives:

- **The “Management Directive”** seeks to give management companies a "European passport" to operate throughout the EU and expands the range of activities which they are allowed to undertake. It also introduces the concept of a simplified prospectus, which intends to provide information in a simplified format to assist the cross – border marketing of UCITSs throughout Europe; and
- **The “Product Directive”** aims to remove barriers to the cross-border marketing of funds by allowing funds to invest in a wider range of financial instruments. This extension not only includes money market instruments, bank deposits, units of UCITS and other collective investment undertakings, but also permits funds to employ financial derivative instruments as part of their general investment policies and not only for hedging purposes.

All UCITSs must be converted to UCITS III before February 2007 if they want to have a “European passport” to operate and market freely within the EU.

2. *What implications does UCITS III have for investors?*

There are two key aspects of the UCITS III Directive ^(Note 1)–

- widen the range of investment possibilities, including financial derivative instruments (“fdi”); and
- continue to set limits in the interest of investor protection.

On fdi, funds may invest in fdi (including OTC derivatives) for investment purposes with a maximum of 100% of NAV. The upside of the expanded use of fdi is that if used correctly, they can provide implementation flexibility, reduce risks, and provide yield enhancement. However, investors should also bear in mind that fdi involve special risks, e.g. counterparty risk, valuation risk, and liquidity risk – a liquid secondary market may not always exist at any time. Also, they may move in unexpected ways and some may magnify or increase the investment losses to the fund.

To balance off the expanded investment powers, the UCITS III regime imposes the following requirements to ensure that there are sufficient checks and balances in place::

- More complex risk-spreading rules
- Institute a risk management process – enable the fund manager to monitor and measure at any time the risk of the fund’s positions
- Extended disclosure duties – the fund manager must report regularly to the competent authority on individual portfolios, the types of derivatives used, the underlying risks, the quantitative limits and methods chosen to estimate the risks associated with derivatives
- Exchange of information amongst member states
- Rule of conduct – to ensure that companies act in the best interests of the UCITS and the integrity of the market

3. *In future, when I buy funds, how do I know which funds are UCITS III compliant and which of them are not?*

Most funds probably would only specify they are subject to the rules and regulations of a particular jurisdiction; and do not explicitly mention their “UCITS III”-compliance status in the offering documents (“OD”).

While UCITS III compliance entails that the fund manager can enjoy expanded investment powers and that there is an appropriate risk management process, the risk and return characteristics of UCITS III funds can vary substantially because each fund can apply the expanded investment powers differently (e.g. when the powers are invoked and the extent financial derivative instruments are used. For instance, while it is noted that a number of funds have sought or will shortly seek for investors’ approval to expand the investment powers, some do not plan to utilize the expanded powers until they deem it as appropriate.) Thus, instead of just focusing on whether a fund is a UCITS III-fund or not, investors should read the OD, in particular the sections on investment objective, policy, restrictions, and risk factors as to gain a better understanding of the risk and return characteristics of the fund.

4. *I have received an EGM notice regarding my fund's conversion to UCITS III. What will I be asked to vote on? How should I make my decision? What factors should I consider?*

A fund's conversion to UCITS III may result in structural changes to the constitutive document (articles of association/incorporation if the fund is incorporated as an investment company, or trust deed if the fund is incorporated as a unit trust) or material changes to the investment objective and policies. Such changes will usually be required to be approved at an Extraordinary General Meeting ("EGM") – 21 days' prior notice is required to be given. At the EGM, shareholders will be required to vote on the proposed changes with respect to the constitutive document of the fund.

Before you vote, you should understand the scope, nature and implications of the proposed changes. You should consider whether the amended investment objective, policies, and risk/return characteristics of the fund will continue to suit your profile and meet your needs. It is advisable if you can consult your distributor and/or fund house before making a decision on voting.

However, it must be noted that if a fund is constituted as a common fund (or FCP, *fonds commun de placement*, a type of UCITS registered in Luxembourg), there is no EGM to vote for the fund's conversion to UCITS III. The fund is only required to send prior notice to the investors re the changes brought about by the conversion.

5. *If the EGM has approved the proposed changes, when will the changes be effective? Who should bear the conversion cost? Will there be any impacts on the fund price?*

Once the proposed changes are passed at the EGM, they can come into effect immediately or at a date as specified and approved at the EGM. For cases where an EGM is not required, in general, up to three months' prior notice should be given before conversion takes effect.

The conversion cost will usually be classified as part of the normal fund administration/maintenance expenses and thus, be borne by the fund. The cost is charged back to the fund and will thus be reflected in the fund price.

6. *If the EGM has vetoed the proposed changes, can the fund still operate and offer to the public in Hong Kong? Will the performance of the fund be affected as a result of the proposal not going forward?*

If the proposed changes of the fund have been vetoed at the EGM, it will not be able to enjoy the "single passport" within the European Community when the grandfathering provision expires in February 2007. In certain jurisdictions, the expiry date may be earlier. Therefore, the fund house may or may not wish to maintain the fund. Practically speaking, it is highly likely that in the interest of investors, if the fund cannot be converted to UCITS III, the fund house would close it down as it can only be marketed to a limited number of markets and it may not be economically viable to continue running the fund. Ultimately, this

involves a commercial decision and it is important that you check with the distributor and/or fund house to see what plans the latter has for the fund if the proposed changes have been vetoed at the EGM.

As to whether the outcome (i.e. whether the proposed changes have been approved or vetoed at the EGM) will have any material impact on fund performance, it probably depends very much on the reactions of the investors – e.g. if the failure to obtain approval for the proposed changes results in uncertainty about the prospect of the fund, more investors may opt for redemption. To the extent that this results in a substantial reduction in the asset size of the fund, the performance of the fund may be affected.

7. *I am against the proposed conversion but the EGM has approved the change. What can I do? Will the fund house provide free switching services or waive the redemption charge if I decide to redeem?*

Before you vote on the proposed changes, it is advisable for you to consult your distributor and/or fund house regarding the fund's future investment policy and risk profile. If you are not comfortable with the proposed changes, you may consider switching to other fund(s) within the same fund house, or redeeming your units from the fund in question. As to whether the fund house or distributor will waive the fees for switching or redemption, it is entirely at each company's discretion and depends on the policies set by the fund house or the distributor.

One other point worth considering is that the vast majority of SFC-authorized funds – over 70% - are domiciled^(Note2) in Europe and most, if not all, will be converted from UCITS I to UCITS III in the next few months. Thus, it is likely that UCITS III funds will become the main stream products.

8. *Does UCITS III have implications for MPF funds?*

MPF funds are HK domicile funds that are subject to HK laws, including rules about investment restrictions and permissible investments. As such, they will not be directly affected by UCITS III. Any investments that they make into SFC authorised funds might be indirectly affected and the MPFA will keep this issue under review.

(End, April 2005)

Notes:

¹ Source: The European Fund and Asset Management Association (“EFAMA”) “The new UCITS Directive explained”. The EFAMA (formerly called the FEFSI) represents the European investment management industry (collective and individual portfolio management) and covers some 41,100 investment funds, with EUR4.7 trillion in net assets under management.

² “Domicile” means the country or territory by whose system of law the scheme or fund is governed.