

CROSS-BORDER FUNDS

Luxembourg positioned for the future

The Grand Duchy's investment fund heritage has prepared it for the challenges ahead.

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Luxembourg and Ireland have dominated cross-border investment fund distribution over the last 25 years; Luxembourg alone has a market share of around 80 percent. A key question for the cross-border investment fund centres today is: what must they do to continue to maintain this position and possibly increase it going forward? To answer this question, it's probably best to first look back and examine the critical drivers in getting it to its current leading market position, and examine whether these still continue to be relevant, or whether new ones are emerging. While I will focus on the Luxembourg perspective, most of the arguments are also relevant for Ireland.

The key drivers of the past

Luxembourg was the first EU country to recognize the potential of UCITS and led the way in being the first country to transpose the initial UCITS Directive way back in 1988. It has also led the way in the transposition of all subsequent directives. Transposition, however, was in each case only the first step – the clarification of how these directives should be interpreted and operate in practice was at least as important. The early transposition and the related practical clarification enabled the international investment management community to innovate their products and operating models. It also resulted in the service providers and the regulator gaining deep and early expertise in product innovation, including and the servicing of the new investment techniques utilized by investment managers to innovate their products, and product approval.

Having been the first mover, Luxembourg has naturally attracted and built up over the last 25 years deep skills in such areas as fund structuring and set-up, fund administration, depositary and custody services and, above all, distribution. Distribution support services, covering not just the EU but the whole of Europe and, importantly, Asia

and Latin America have become critical in order to develop a true international platform.

Luxembourg quickly evolved to provide the complete “*toolbox*” consisting of an array of regulated investment fund vehicles with flexible features to cater for all investor types and all asset classes.

Built up over many years, Luxembourg's brand and reputation is rooted in the DNA of the country and its government – in particular, its attitude and its focused approach towards the investment fund industry (one of strong encouragement and support), its consistency and certainty on legislation including taxation.

This brand and reputation have enabled two critical things to happen in Luxembourg: first, it has encouraged the international asset management players to set up substantial operations in Luxembourg and, second, enabled “*made in Luxembourg*” investment fund products to gain unrivalled access to an international investor base.

The drivers of the future

First mover advantage is and will continue to be important especially when one considers recent directives, such as UCITS IV, where many of its provisions are geared at simplifying and reducing the costs of creating, managing and distributing investment funds. However, first mover advantage can be somewhat diluted because cross-border centres, such as Luxembourg, are to some extent dependent on the pace at which other EU countries implement the directives in order to ensure the fund sponsors and the underlying investors gain the full benefits of the new provisions (e.g., cross-border UCITS master-feeders and mergers). Many of Luxembourg's main EU “*export*” markets tend to be slower in implementing these new legislative measures.

Deep support services will continue to be a critical defining criterion in the selection of a fund domicile centre. The level of sophistication of services such as risk management, distribution sup-

port (especially for the high growth markets such as Asia) and product development expertise (to fit and grow with the development of new products, such as alternative UCITS and ETFs) will continue to be important. With the decoupling of the fund and management company domiciles, service provider due diligence and oversight along with client relationship management will become ever more important.

Brand and reputation is and will continue to be probably the overriding credential. Put very simply, each fund sponsor who wishes to deepen and/or expand its international distribution will ask themselves whether the domicile of the fund help, hinder or be of no relevance.

Apart from UCITS IV, the much debated AIFM Directive is also likely to favour international cross-border platforms for alternatives, and may facilitate the development of a global professional investor “*AIF*” brand, reflecting the global success of the “*UCITS*” brand. Whilst Luxembourg is well placed to leverage its UCITS experience, it will need to make further investments in the areas of infrastructure, approval process, training and marketing, in order to be well placed to repeat its UCITS success.

Investors, and especially retail investors (especially in case of UCITS), may influence the cross-border model going forward. Currently, European retail investors' tastes vary: in certain countries retail investors tend to be very comfortable buying cross-border funds (e.g., Germany and the Netherlands) whilst in others (e.g., the UK and France) they still prefer domestic domiciled funds. Institutional investors are not “*stuck*” on a particular country domicile, but more concerned about issues such as quality of regulation, costs (including any tax leakage), quality of support service, time to market and sophistication of the available “*toolbox*”.

The newly introduced Key Investor Information Document may prove to be an interesting device in highlighting the differences between the “*cost*”



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of domestic and international fund platforms of the same fund sponsors for similar products. This can only increase the pressure on the product manufacturers to attempt to gain further economies of scale and reduce cost. This may very well be achieved by having “*mega*” investment fund platforms catering for both domestic and international investors. Emerging competition in the form of an Asia-Pacific passport for investment funds has been the subject of much speculation over the last year. Whilst there are the obvious infrastructure, legal, tax and cultural challenges to overcome in order to turn this concept into reality, the biggest challenge is probably the protectionist nature of the majority of the countries involved. However, this will not prevent bilateral arrangements

between certain of the countries (there have already been some examples) and overt measures being taken by certain governments to promote local players (for example, Taiwan and Korea). Ultimately the most cost-efficient solutions will win out in spite of the artificial barriers which are put in place – the only issue with this is that, in the meantime, the underlying investor ends up paying the price of what is on offer.

Conclusion

The current established cross-border platforms will continue to dominate and expand for the foreseeable future, driven by the need of the fund manufacturers to leverage “*mega*” UCITS platforms to serve both a domestic and international

clientele on a cost-efficient basis. However, the established cross-border platforms will need to constantly focus on the quality of infrastructure and costs to protect their market positions, in particular. In addition, there must be much more direct engagement with the non-European regulators in order to ensure their concerns regarding regulatory and other changes are listened to and addressed. Finally, should the established cross-border domiciles wish to repeat their UCITS success with the AIFM Directive, they will need to make a substantial investment in infrastructure (including the regulatory approval process), training, marketing and need to build a series of bilateral recognition agreements with the non-EU alternative investment management centres. ●