



STATE STREET.

Mr. Niall Bohan
Head of Unit DG MARKT G4
European Commission
B- 1049 Brussels

October 2, 2006

**RESPONSE TO THE REPORT OF THE EXPERT GROUP ON INVESTMENT
FUND MARKET EFFICIENCY**

State Street Corporation, headquartered in Boston, U.S.A., specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With \$10.9 trillion in assets under custody and \$1.5 trillion in assets under management State Street operates in 26 countries and 100 markets worldwide. Our European-based workforce of over 5,400 employees represents 20% of our global headcount. As of June 30, 2006, State Street holds assets under custody from clients in Europe totalling \$1.6 trillion and client's assets under management totalling \$ 373 billion. State Street distributes its own (UCITS and non-UCITS) fund products to institutional clients only.

Dear Niall,

State Street Corporation would like to thank the Commission for the opportunity to comment on the report of the Expert Group on Investment Fund Market Efficiency. We would like to offer both general observations for the Commission's consideration, as well as comments relative to the specific measures proposed by the expert group.

We would be happy to discuss with you, in further detail, any comments you may have. Please do not hesitate to contact Gabriele Holstein at 0041 44 560 5101.

Sincerely,

Stefan Gavell
Executive Vice President
Industry and Regulatory Affairs

Dr. Gabriele Holstein
Vice President
Industry and Regulatory Affairs Europe

**State Street Corporation's Response to the Report of the
Expert Group on Investment Fund Market Efficiency
("the Report")**

Introduction

This memorandum contains State Street's response to the report of the expert group established by the Commission on Investment Fund Market Efficiency. We appreciate the opportunity to share our views and comments on this important document. As a major global custodian and large institutional asset manager, we would like to offer both general observations for the Commission's consideration, as well as comments relative to the specific measures proposed by the expert group.

In our view, the report provides clear and workable recommendations, with an impressive level of detail and confirms that there is strong consensus on how to overcome existing barriers to cross-border business. The steps required to enhance the single market have been identified as follows: (i) Getting products to the market more quickly through simplification of the UCITS registration process (ii) facilitating cross-border mergers of UCITS, (iii) allowing fund assets to be pooled cross-border (iv) making the management company passport work and (v) providing more freedom for the depositary.

We believe that all of the above measures are equally important to the asset management industry, and that they will provide significant benefit to both the industry as well as the end-investor. It is now time for the Commission to take action and to move these proposals forward as soon as possible. In the interest of quick delivery, the Commission should determine on a case-by-case basis whether non-legislative or targeted legislative initiatives are required. Where amendments to the UCITS Directive are required to implement the proposal, they should be considered under the Lamfalussy procedure.

While we are also supportive of a general move to a Lamfalussy approach, we believe that the re-writing of the UCITS directive as a whole should be left to a later stage, as this is likely to divert Commission resources from addressing the key steps listed above. We therefore would like to emphasize our agreement with the expert group's call for a

focused, short-term agenda to be implemented at the member state level within the next three years.

State Street's comments to the specific measures proposed:

(i) Getting products to the market more quickly

We agree with the expert group's view that, although designed to facilitate the pan-European marketing of UCITS, the UCITS notification procedure has become a long, expensive and administratively complex process. As a result, investors have less choice, the industry is denied opportunities and both suffer higher costs. The expert group recommends that this problem be resolved by:

- (a) amending the UCITS Directive to align its authorization and notification rules with those found within the Prospectus Directive, meaning authorization of funds in 20 business days and electronic regulator-to-regulator notification taking a maximum of three days.
- (b) revisiting the simplified prospectus so that it becomes a fully and automatically recognized document containing key disclosures for investors. The simplified prospectus (including any translations thereof) should be communicated as part of the cross-border notification and should not be the subject of further examination by the host authority.

We believe that further legislative improvements to the notification regime is a sensible route to take. The scope of the recent CESR consultation to simplify the notification process was limited to the current text of the UCITS Directive. While the CESR guidelines are clearly an improvement over the current situation, we believe that more work needs to be done. We therefore suggest that the CESR guidelines be implemented without further delay, and that work commence on a new notification regime, targeting completion within the proposed three-year timeframe.

We also welcome the suggestion that the simplified prospectus should not be subject to further examination by the host authority. As already outlined in our response to CESR,

host state regulators should not be challenging the UCITS passports based on different interpretations of the UCITS Directive. While the CESR guidelines ensure that this will no longer be the case, we believe amending the Directive with further clarification would be useful.

In addition, we would also encourage the Commission not to overlook the substantial impact of the divergent post-authorization requirements for UCITS which exist across member states (e.g. divergent rules of what needs to be included in the annual report). Host state authorities should be able to request only information as specified in the Directive (fund rules or instruments of incorporation, full and simplified prospectus, annual and half-yearly reports). As these documents are attested by the home state regulator, there should be no further need for double-checking or for requesting more detailed information to be included in the document by the host state regulator.

A point which we have already raised in our response to the CESR consultation and which we would like to reemphasize is the requirement that a UCITS must, in accordance with the regulations of a host state, take measures to ensure that local facilities are available for making payments to unit-holders (Article 45). This mandatory appointment of a local paying agent should be reviewed in light of modern electronic payment facilities, which allow institutional investors to deal directly with the administrator, rather than paying agents. The requirement leads to inefficiencies in the structuring of cross-border marketing operations by creating unnecessary, additional distribution costs, which are ultimately borne by the unit holders. The diverging approaches among the individual member states should also be addressed to minimize legal uncertainty.

(ii) Facilitating cross-border mergers of UCITS

The UCITS Directive does not provide any mechanism for merging investment funds. While there are economic benefits to cross-border mergers, challenging obstacles such as divergent corporate laws, tax regimes and investor protection rules stand in the way of a much needed consolidation of the investment fund landscape. In order to allow for cross-border fund mergers, the expert group recommends:

- (a) expanding the UCITS Directive to include arrangements for fund mergers to take place, subject to safeguards that protect investor interests and enjoy supervisory confidence;
- (b) taking actions to ensure that fund mergers do not give rise to adverse tax implications.

We strongly agree with the expert group's proposal to amend the UCITS Directive, as well as to put in place a separate Taxation of Fund Mergers Directive to facilitate the cross-border mergers of funds. Without the proposed separate Directive, the issue of tax inefficiency is unlikely to gain sufficient attention. The suggestion that the new directive is to be based on the existing Taxation of Mergers Directive (90/434/EC) is a sensible approach to take.

Furthermore, we share the view that protection of investors in the merger process is key and that the rights of UCITS investors as listed in the report (such as the right to receive adequate information regarding the merger and the right to exit without charges should they not wish to participate), need to be ensured.

The two concerns we have in respect to facilitating the cross-border mergers of funds are the following:

- (i) Firstly, we fear that the legislative process, especially the tax discussions, could take a long time to achieve results. It is therefore important to ensure that fund merger related tax issues do not hold back the implementation of other measures. If this turns out to be the case, cross-border fund mergers should be put on the mid-term agenda.
- (ii) Secondly, we believe that careful consideration should be given as to the implications of the suggestion that the regulator of the fund that will no longer exist after a merger is to approve the merger. Similarly, the current wording of section A.iii. of the Expert Group Report implies that national regulators would apply their own information requirement regarding the merger ("each regulator will obtain *appropriate* information regarding the merger concerning the fund in their jurisdiction that is subject to merge") rather than those

of the host authority. In our view, these suggestions are likely to not only increase the administrative complexity of the fund merger process, but also open the door to potentially protectionist regulatory requirements. We therefore recommend agreement on standardized information requirements for mergers, as well as the specific circumstances under which a proposed merger can be declined.

(iii) Allowing fund assets to be pooled cross-border

Today, investment managers are often unable to pool the assets of the UCITS that they manage on a cross-border basis. We share the expert group's view that this is a significant impediment to the efficiency of the single market. Cross-border pooling is an important tool in achieving portfolio consolidation. The benefits of asset pooling and similar commingling structures are already evident at the national level in a number of member states as well as in some financial sectors. For example, the insurance sector already makes extensive use of pooling techniques.

In order to generalize these commingling possibilities at a European level, the expert group recommends the following measures:

- (a) removing provisions of the UCITS Directive that preclude master-feeder and other forms of entity pooling;
- (b) building an understanding between regulators in order to allow the wider application of virtual pooling techniques;
- (c) introducing necessary flanking conditions, such as recognition of the right for the depositary to appoint a custodian based in another EU state (see depositary section below).

We believe that the expert group has identified the right steps to facilitate pooling. A harmonized approach and regulatory framework for cross-border pooling would strongly benefit the EU fund market by considerably reducing fund management and administration costs. State Street believes that as the custody function is often performed outside of the jurisdiction of a fund, harmonized rules for cross-border pooling

should be relatively easy to establish. In this regard, we would like to particularly stress the importance of measure (c).

(iv) Making the management company passport work

The UCITS framework artificially imposes a geographical organization of the value chain, as all funds must have a local depositary/custodian and a local management presence. State Street supports the position that a management company established in one member state should have the ability to establish and operate a UCITS fund in another member state. Such a passporting regime will produce economic benefits to fund investors by allowing management companies to eliminate replication of resources by leveraging compliance, portfolio management and marketing staff across a number of locations. We agree with the expert group's view that under the current structure, costs are unnecessarily duplicated across fund domiciles, which prevents the industry from reaping specialization and efficiency gains and increases operational risk.

In order to provide much-needed flexibility for management companies and depositaries/custodians without sacrificing investor protection or effective supervision, the report suggests that fund managers should be able to provide core management services to funds domiciled in other member states. This would pave the way for a rational organization of the industry based on specialization. The UCITS III amendments tried to translate this idea into practice but fell short.

The expert group proposes to revisit this issue by:

- (a) eliminating the inconsistencies and omissions that have robbed the management company passport of its effect;
- (b) extending the right to manage funds on a remote basis to all types of funds (not just corporate funds);
- (c) removing the "head office" principle or replacing it with a "key activities" or similar concept;
- (d) providing clarity on the activities and services which the management company can provide on a cross-border basis.

We endorse these measures and believe that potential concerns regarding the splitting of supervisory responsibility can be solved without causing an onerous conflict. Fund operation and distribution matters should be the responsibility of the management company's home state regulator and fund formation matters, which are matters of national law, such as property, contract, corporate and commercial law, the responsibility of the regulators of the states in which the fund would be established.

(v) Providing more freedom for the depositary

The expert group believes that several pre-conditions must be met prior to establishing any EU depositary passport, given the depositary's essential function for investor protection. Pending further work on this front, the group recommends:

- (a) enabling branches of banks from other member states to act as a depositary;
- (b) allowing the depositary to be free to delegate asset-safekeeping to custodians in another EU member state, subject to the custodian complying with the depositary's local regulations on a contractual basis.
- (c) In the longer term, the Commission should harmonize the capital requirements of depositaries and study the barriers to further harmonizing the role and responsibilities of the depositary

We strongly share the expert group's view that while further work is required to address the challenges of a cross-border depositary passport, there are opportunities for the Commission to improve efficiencies in the near-term.

In regards to **improving efficiencies in the near-term**, we agree with the two measures as identified by the expert group and provide additional comments as follows:

- (1) Allowing branches of banks from other member states to act as a depositary:** In our view, such a "branching passport" for depositaries could be regarded as an alternative to a cross-border passport regime. This would be particularly valuable in those markets where the depositary is required to be a credit institution. Allowing branching of credit institutions would make better use of capital and management resources and is consistent with the Banking Directive. Having a branch in the same location as the

fund would alleviate concerns in respect to the segregation / insolvency protection function, as well as different rules on depository responsibilities.

- (2) **Consistent rules regarding delegation and outsourcing of the safekeeping and administrative function:** Most jurisdictions will allow the depository to hold all fund assets through a securities account (and a cash account) opened with a global custodian. Some jurisdictions, however, impose cumbersome restrictions on the outsourcing of the safekeeping functions by effectively requiring that the depository operate as a global custodian itself and open securities accounts directly with the central securities depositories in each jurisdiction in which the relevant fund is invested. Consistent authorization to outsource the safekeeping to a global custodian authorized in any member state would reduce these unnecessary and costly barriers.

In respect to the **long-term challenge of establishing a cross-border depository passport**, we would like to reemphasize the two key concerns we already raised in our response to the Green Paper:

- (1) **Splitting of supervisory responsibilities:** This is an issue difficult to resolve as each jurisdiction relies on its local property laws to achieve the goal of segregation and insolvency protection¹. Common law jurisdictions, for instance, rely on the trust structure and hence, there is no need for the depository to be heavily capitalized. Other jurisdictions are not able to em-

¹ We like to draw the following distinction between the key functions of a depository (i) **Segregation / Insolvency protection function:** The segregation of the fund assets from the assets of the management company and consequently, the protection of the fund assets from the insolvency of the management company or the depository. (ii) **Monitoring or oversight function:** the responsibility to supervise the management company in the proper discharge of its fund operating responsibilities. This function is also referred to as the depository's "fiduciary" function. (iii) **Asset administration function:** responsibility of the depository to ensure that the fund assets are *safe kept* (e.g. by depositing the assets with a global custodian) and *administered* (i.e. that trades are settled, income is collected, voting rights are exercised and corporate actions are dealt with).

The segregation / insolvency protection function under (i) and the asset administration function under (iii) are what is often referred to as the depository's "*safekeeping*" function.

ploy the trust structure as a segregation technique and may therefore rely on bankruptcy remote special purpose vehicles (e.g. the Netherlands) or on the fact that the depositary is regulated as a credit institution (e.g. in Germany, Austria and Italy). Difficulties would arise if a depositary providing cross-border services is required to ensure insolvency protection under the laws of another member state, as it is questionable whether property concepts employed to achieve segregation in one jurisdiction would be recognized in the event of insolvency of a depositary in another jurisdiction.

- (2) **Differing role and responsibilities of depositaries in member states:** In some jurisdictions, depositaries are only required to calculate asset values, while in others they also need to approve them. Yet in other jurisdictions, the depositary has a very limited role in the NAV calculation and is limited to a duty of oversight. Such examples illustrate how strongly the roles and responsibilities of depositaries differ between the member states today.

We share the expert group's view that studying the barriers to harmonizing the role and responsibilities of the depositary, as well as harmonizing the capital requirements of depositaries are important measures for the Commission to consider in the long-term. The economic and regulatory case for a cross-border depositary passport, however, still has to be made.