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Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS

Asset Management

Exposure Draft

Initial orientations for discussion on possible adjustments to the UCITS Directive

2. Management company passport

Important note: *This document is a working document of DG MARKT services which is published for discussion purposes only. It presents DG MARKT services preliminary reflections on possible future adjustments to the UCITS Directive. It does not necessarily reflect the views of the European Commission. The Commission retains full autonomy and discretion as regards the content of any subsequent legislative proposal.*

1. Assessing the impacts of improvements to the management company	2
2. Shape of possible adjustments to the UCITS Directive	9
3. Questions	26

1. Assessing the impacts of improvements to the management company passport

1.1. Background

Changes to the UCITS Directive in 2001¹ introduced a passport for the management company. Art. 6 of the amended Directive provides that an authorised management company (MC) can provide services in another Member State (MS) either through the establishment of a branch or under the freedom to provide services. This new freedom was however not open to all types of funds. The passport for the MC was only possible in the case of corporate funds. Funds of a contractual form have to be established in the MS of their MC.

Notwithstanding the introduction of this new freedom, the management company passport (MCP) has not materialised. Ambiguities in the text of the Directive and important concerns relating to splitting supervisory responsibilities between two authorities have hindered their implementation. As a result, fund promoters need to establish a full fledged MC in every MS where their funds are located. This is estimated to generate costs in the range of €500,000 to 1 million per MC and year.

The White Paper's impact assessment (IA) analysis concludes that efforts to make the MC passport work are largely justified by the expected savings. It also suggests eliminating the discrimination between corporate and contractual funds. However, some questions remained without unequivocal answer: notably the scope of the passport, the effectiveness of supervision and possible tax implications. The following analysis seeks to provide further explanation on these points following additional research by DG Markt services.

1.2. Option description

Option 1: Full passport

This implies that the MC authorised/based in MS A will be allowed to manage, administer and market corporate and contractual funds in MS B either through the establishment of a branch or under the freedom to provide services (i.e. all functions in annex II can be 'passportised').

This would necessitate clarifying relevant MCP articles of the Directive (including extending this freedom to contractual funds). Split supervision concerns would require changes to the co-operation mechanism between regulators².

¹ Directive 2001/107/EC of 21st January 2002 amending the UCITS Directive (85/611/EEC)

² In order to reduce supervision related concerns, other possibilities are to impose additional obligations for the management company and/or depository. However, the analysis conducted has proven that these would have a limited positive impact on investor protection but important implications in terms of compliance costs for the industry. (And these risk to offset the savings achieved by the passport.)

Pros

- More flexibility: the fund promoter can decide how to organise its business geographically
- Specialisation gains
- Greater cost savings
- It will allow an already existing situation (geographical concentration of management is a reality), while eliminating the need to set up ineffective arrangements (e.g. delegation)

Cons

- Possible risk of adverse tax implications
- Important split supervision concerns on the side of supervisors.
- It may be more difficult for the depositary to fulfil its duties

Option 2: 'Partial' passport

This implies that the MC of a corporate or contractual fund domiciled in MS B would be able to perform some of its functions from MS A, where the MC is authorised/based (i.e. only some of the functions in annex II can be 'passported'). The main question then is which functions should remain in the fund domicile.

Comment: Out of the set of functions in Annex II the most controversial, from the passport point of view, seem to be those related to fund administration³. It is argued that it will be more difficult for the depositary to fulfil its obligations if the administrative functions are carried out in another country⁴. From the point of view of the fund supervisor, if all administrative functions are performed from abroad, the supervisor may have no real role or ability to meet the responsibilities assigned to it. The discussion on the partial passport concentrates then on the minimum set of administrative functions that should remain in the fund domicile in order to reduce those concerns.

Pros

- Possibly reduced split supervision concerns and lower risk of adverse tax implications
- It will allow an already existing situation without needing to enter into costly and complex delegation arrangements
- Easier (and cheaper) for the depositary to fulfil its duties.

Cons

- For corporate funds it could be seen as a step back (art. 6 hints a full passport).
- Lower cost savings
- Less flexibility for industry to organise its business on a pan-European basis

³ Cross-border investment management already takes place (through delegation). Marketing should not be a problem since compliance with art. 44-47 (product passport) is in any case required.

⁴ However, according to discussions with some parts of the industry, this may not be always a problem considering modern communication means.

1.3. Impact analysis⁵

Option 1: Full passport

A. Compliance costs

Clarifications to the text of the Directive should not have an impact from an industry and legal compliance point of view⁶. Changes to the co-operation mechanism, may imply additional costs for regulators. Adjustment costs would be higher at the beginning of the implementation of the new working arrangements and decline subsequently. Magnitude of costs would very much depend on the design of the reviewed mechanism to be worked out in detail at Level 2. In order to minimise compliance costs, Level 1 changes could include new provisions on powers and instruments at the disposal of regulators that are in line with those already introduced by other Directives (such as MiFID⁷). Thus, the direct impact of Level 1 changes on the costs for regulators would be limited.

B. Economic benefits

Operational savings of €381 to €762 million/year have been estimated in the case that each asset management group would be allowed to operate from only one location⁸. To these it should be added the savings stemming from initial investment costs (capital requirements, formation costs, systems investment, installation costs...). Nor would there be any need to enter into expensive delegation agreements or to 'buy substance' (some €650,000 per MC and year⁹). It is also argued that centralisation of management company activities would enhance the quality of risk management.

On the other hand, the use of the passport may increase the costs for the depositary¹⁰, e.g. if compliance with national rules require 'in situ' inspections. Some also consider that a full passport may have unintended tax implications which risks limiting the advantages of such a passport¹¹.

⁵ This section should be seen as a preliminary analysis of the potential implications of the different options. A more detailed impact assessment will be carried out at a later stage.

⁶ If any, this cost impact would be positive since it will save time and costs linked to legal teams' efforts to interpret Directive provisions on this area.

⁷ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

⁸ Please see Impact Assessment report published along with the White Paper on investment funds.

⁹ Data from industry contributions.

¹⁰ However, it is also argued that since the management is already performed often from abroad, little would change in the relation between MC and the depositary (e.g. communication systems are already in place).

¹¹ It has been argued that if a fund domiciled in country A is managed by a MC based in country B, the tax authorities of country B could consider that all fund's activities take place in country B and claim jurisdiction over the fund. The fund would be then taxed twice: in its fund domicile and in the country of its MC. This, however, remains an unproved risk. It could also be argued that Member States do not have an interest to deprive their own fund management industry of the opportunities offered by the passport. Experience from related sectors (e.g. investment manager exemption in UK for overseas non-transparent structures) demonstrates that tax authorities can be responsive to these considerations.

C. Investor protection impacts

Supporters of the (full) passport anticipate an increase in investor protection since delegation arrangements render the monitoring by the fund manager more difficult. Advocates of the full passport also claim that centralisation should lead to an improvement in the quality of the management. (It should also be recalled that, even if a fund is managed from another country, its MC needs to ensure compliance of the fund with the rules applicable in its country of domicile.)

On the other hand, it has been argued that the MCP could also endanger the high level of investor protection offered by the UCITS Directive. The arguments to this effect are that it would be more difficult for a) the depositary to fulfil its duties; b) the investor to address his/her complaints in the event of a problem and c) the regulator to supervise (since the passport risks creating letter-box entities). The first two arguments have been challenged. Physical presence of the depositary in the country of the MC does not seem to be a necessary pre-condition to correctly fulfil its obligations. There is also rarely a direct relationship between the management company and the investor (even in a purely national scenario, distribution of funds is generally carried out by an intermediary/distributor)¹². The third argument, however, needs careful consideration.

Letter-box related concerns are important among regulators. Effective supervision could be jeopardised if the fund is just a virtual/legal construction emptied of any substance and devoid of any activity, leaving supervisors in a situation where they have difficulty in discharging their responsibilities. This situation could reduce effective oversight of part of the fund value chain. A simple clarification of the MCP provisions does not seem to fully address those concerns¹³.

Option 2: Partial passport

A. Compliance costs

Implementing a partial passport will have limited (initial) compliance costs for the management company. These could be the result of (one-off) investments in IT/communication systems between the MC main office and the administrative centre, of restructuring of operations, etc. Given that some MC's activities are de facto already performed outside the fund's domicile, these investments may already have taken place. In any case, in the long-term compliance cost would be close to zero.

B. Economic benefits

Costs related to capital and other substance requirements could be saved. The Directive imposes capital requirements of at least €125,000. Considering the EURIBOR rate (1year) for December 2006 (3.92 %), this would imply a cost of capital of between €3.7 and €300

¹² It also needs to be noted that the same argument could be given in the case of a foreign fund notified in the country of the investor.

¹³ This statement is based on the contributions to the Green Paper and to the Expert Group on Market Efficiency consultations, as well as on bilateral discussions with different MS regulators.

million per annum¹⁴. Likewise, elimination of the need to appoint local directors can have an important impact on substance costs. (In its contribution to the Green Paper, EFAMA estimated at around €500,000 the annual cost of appointing two "conducting officers" to a self-managed SICAV.)

However, the need to keep a team in the fund domicile to perform (or verify the carrying out of) some administrative functions will still entail a certain level of (initial investment and) annual operating costs¹⁵. In order to maximise the savings linked to the (partial) passport, the administrative functions remaining in the fund's domicile should be kept to the minimum needed to underpin effective supervision and oversight of the fund chain. Research and discussions with the industry and regulators suggest that two functions are potentially relevant in reducing empty-substance related concerns. These are a) verification of valuation and pricing and b) maintenance of the unit-holder register.

C. Investor protection impacts

If some administrative functions are performed in the domicile of the fund, this would mitigate letter-box related concerns. It could also avoid possible negative tax implications (that at the end of the day would have had to be assumed by the investors). A minimum of substance would help to demonstrate (vis-à-vis tax authorities) the establishment of the fund in its domicile.

This option may however still require a reinforcement of the co-operation mechanism between regulators in order to address potential gaps in supervision due to split responsibilities.

1.4. Preferred option

Three reasons are generally put forward to justify the need for a MC to be established in the fund's country: 1) to ensure a better supervision by national authorities, 2) to allow the depositary to fulfil its duties and 3) to make it easier for investors to submit their complaints. The analysis above shows that supervisory concerns deserve the most attention.

The options analysed focus on how to overcome these supervisory related concerns. Those derived from the split of supervision between regulators require a clear definition of the respective roles and supervisory powers available to each national authority. As for the need to ensure effective supervision, retaining a minimum of substance in the fund domicile may be sufficient to allay concerns about supervisory effectiveness. Taking all this into account, option 2 is the one which best serves the single market. Since some administrative functions will remain in the fund domicile, the economic outcomes of this option are however lower than those for option 1. The set of administrative functions will then need to be kept to the strict minimum in order to maximise the benefits of the passport.

¹⁴ Minimum capital requirements are higher for funds managing over 250 million assets (namely €10,000 higher for each €50 million above that threshold) and can amount up to €10 million. FERI data has been used to calculate the reduction in the number of MCs. (According to FERI, in 2006 there were 1749 active European management companies belonging to 987 groups.)

¹⁵ Staff overheads, IT systems, office rental, etc.

1.5. Impact table

Impacts on → Option ↓	Compliance costs	Economic benefits	Investor protection	Preferred option
Full passport	neutral	++	-	—
Partial passport	neutral	+	neutral	X

1.6. Rationale behind other key choices made in respect of possible adjustments to UCITS Directive

Definition of the passport: Article 6 of the Directive, in combination with other Directive provisions, has led to confusion regarding the right of a MC to carry out its activities in another MS. It appeared necessary to explicitly confirm that this included the activity of collective portfolio management and all the services for which the MC has been authorized. The freedoms entailed by the passport are also clarified in the envisaged possible adjustments described in Section 2. The passport not only encompasses the right for a MC to manage a UCITS domiciled in another MS but also for a UCITS to appoint a MC based in another MS. Thus, envisaged adjustments add clarity and should not have an adverse impact from either a cost or investor protection point of view.

Definition of domicile: The domicile of the UCITS is defined in the Directive as the MS where the investment company (i.e. the UCITS itself) or its management company (for unit trusts or common funds) is established. In the first case, this was redundant (if not confusing). In the second case, this was highly restrictive. A definition of the fund's domicile having regard to the applicable law and a set of core administrative functions performed in that MS seems more coherent. It would also allow the industry to achieve most of the savings associated with the passport while at the same time addressing supervisory related concerns.

Extension of the passport to contractual funds: Contributions from sector experts, and responses to consultations, confirmed the need to end the arbitrary distinction between corporate and contractual funds. The new definition of fund domicile should remove any justification for that distinction. The extension of the passport to contractual funds will considerably increase the benefits of the MCP.

Co-operation between regulators: Several national regulators have expressed concerns relating to the split supervision scenario that could follow from the MCP. Potential supervisory gaps are therefore addressed by four types of possible adjustments aiming to strengthen effectiveness of supervision and cross-border cooperation¹⁶. These are measures aiming to a) ensure equivalence of powers, b) develop the existing exchange of information mechanisms, c) reinforce the instruments at the disposal of regulators (such as on the spot verifications) and d) add emergency powers (where the protection of investors is at risk). The

¹⁶ Please see chapter 6 on 'Supervisory cooperation'.

design of these measures has been inspired by MiFID. Compliance costs for national authorities should be quite limited.

Need for double passport removed: The Directive contained an incongruity. Article 6a(5) required a management company to comply with the MCP notification, in addition to the product notification (art. 46) when only distributing its UCITS in another country through a third party. Separation of both notification procedures would add clarification and reduce costs wherever that incoherent paragraph was literally applied.

2. Shape of possible adjustments to the UCITS Directive¹⁷

Directive 85/611/EEC	Envisaged adjustments
<p style="text-align: center;">Section I</p> <p style="text-align: center;">General provisions and scope</p> <p style="text-align: center;"><u>Article 1a</u></p> <p>2. 'management company' shall mean any company, the regular business of which is the management of UCITS in the form of unit trusts/common funds and/or of investment companies (collective portfolio management of UCITS); this includes the functions mentioned in Annex II;</p> <p>3. a 'management company's home Member State' shall mean the Member State, in which the management company's registered office is situated.</p> <p>[...]</p> <p>5. a 'UCITS home Member State' shall mean:</p> <p>(a) with regard to a UCITS constituted as unit trust/common fund, the Member State in which the management company's registered office is situated,</p> <p>(b) with regard to a UCITS constituted as investment company, the Member State in which the investment company's registered office is situated;</p>	<p style="text-align: center;">Section I</p> <p style="text-align: center;">General provisions and scope</p> <p style="text-align: center;"><u>Article 1a</u></p> <p>2. 'management company' shall mean any company, the regular business of which is the management of UCITS in the form of unit trusts/common funds and/or of investment companies (collective portfolio management of UCITS); <i>which consists in</i> the functions mentioned in Annex II;</p> <p>3. a 'management company's home Member State' shall mean the Member State, in which the management company's registered office is situated.</p> <p>[...]</p> <p>5. a 'UCITS home Member State' shall mean, <i>whether the relevant UCITS is constituted as a unit trust/ common fund or as investment company, the Member State which fulfils the following criteria:</i></p> <p><i>(a) the following UCITS administrative functions are actually performed on its territory:</i></p> <ul style="list-style-type: none"> - <i>Verification of valuation and pricing;</i> - <i>Maintenance, where applicable, of unit holder/ shareholder register.</i> <p><i>(b) the law of such Member State is applicable to the UCITS, as provided for in its instruments of incorporation/ fund rules/ trust deed.</i></p> <p><i>An "investment company's home Member</i></p>

¹⁷ Provisions on supervisory cooperation are set out in a separate section.

<p>[...]</p>	<p><i>State" shall be understood as having the same meaning as a UCITS home Member State.</i></p> <p>(a) with regard to a UCITS constituted as unit trust/common fund, the Member State in which the management company's registered office is situated;</p> <p>(b) with regard to a UCITS constituted as investment company, the Member State in which the investment company's registered office is situated;</p> <p>[...]</p>
<p><u>Article 3</u></p> <p>For the purposes of this Directive, a UCITS shall be deemed to be situated in the Member State in which the investment company or the management company of the unit trust has its registered office; the Member States must require that the head office be situated in the same Member State as the registered office.</p>	<p><u>Article 3</u></p> <p>For the purposes of this Directive, a UCITS shall be deemed to be situated in the Member State in which the investment company or the management company of the unit trust has its registered office. The Member States must require that the head office be situated in the same Member State as the registered office</p>

Explanatory comment

1. The existing UCITS domiciliation rule¹⁸

The existing Article 3 of the UCITS Directive deals with fund domiciliation. The aim of this rule is (i) to avoid the creation of letter box UCITS and (ii) to facilitate the work of the supervisory authorities by ensuring that all relevant documentation is kept in their country. This rule is based on a double requirement: (i) a formal requirement, i.e. that the registered office of, as the case may be, the investment company or the management company, be situated in such Member State and (ii) a substance requirement, i.e. that the head office (central administration) functions of such investment company/management company be located in the same Member State as the registered office. It is up to the Member States to determine what this "head office" criteria encompasses, i.e. the degree of substance which has to be met by an investment company/ management company to meet the criteria.

This current approach to domiciliation is a potential obstacle for a management company to use the management company passport to manage a UCITS on a remote basis:

(i) the criteria of the registered office of the management company to determine the home Member State for a common fund/ unit trust is incompatible with the possibility to extend the

¹⁸ On the revised definition of management company under Article 1a (4), see Article 5(2) below.

management company passport¹⁹ to such funds²⁰, as provided for in the Commission White Paper;

(ii) Member States may impose that all management functions be actually performed on their territory as a condition for the head office requirements. This can prevent the management of a UCITS on a remote basis.

On the other hand, the possibility of a full performance of the management of a fund on a remote basis could lead to the creation of letter boxes entities and thus imply two risks:

(i) it could undermine the capacity of the fund supervisor and depositary to assume certain responsibilities with respect to the administration and operation of the fund.

(ii) it could lead to the tax authorities of the management companies domiciles claiming jurisdiction over the incomes and the revenues of the fund, in addition to taxation in the fund domicile itself. This risk would be most pronounced for fiscally non transparent funds.

2. Proposed alternative

To enable the benefit of the management company passport for investment companies and common funds/ unit trusts while avoiding the creation of letter box entities and mitigating the above risks, it would be thus necessary to propose a harmonized approach to the degree of substance/ head office criteria required on the territory of a given Member State. It should become possible, on the basis of clear and operational tests, to identify the respective domiciles of the fund and of the management company where the management company passport is used.

First criterion: performance of core administrative functions

The domiciliation of the fund, whether it is constituted as a unit trust/ common fund or as investment company, should be based on certain core administrative functions which should actually be performed in the Member State where the fund promoters wish the UCITS to be located.

The core administrative functions would be:

- Verification of the valuation and pricing;
- Maintenance of the unit-holders registers.

Maintaining these core administration functions in the fund domicile could avoid the creation of letter box UCITS and facilitate the work of the supervisory authorities, while enabling remote portfolio management. It would not be possible for a Member State to impose more functions to be performed on its territory in the context of remote management pursuant to the management company passport.

¹⁹ i.e. the possibility for a management company, authorised by its Member State authorities, to carry out in another Member State the activity(ies) for which it has been authorised, either by the establishment of a branch or the freedom to provide services, subject to a notification procedure.

²⁰ Which, for the purpose of this text, shall also encompass unit trusts.

Second criterion: applicable law

As explained earlier, a criterion of domiciliation of a UCITS based on the registered office of the management company is incompatible with the remote management of a common fund/ unit trust. An alternative proposal would rely on a legal criterion, i.e. the law applicable to the common fund/ unit trust/investment company. This needs also to be reflected in the existing definition of UCITS home Member State, which relies also on the concept of the registered office.

Accordingly, we would envisage to replace (i) the existing Article 3 on domiciliation and (ii) the definition of the UCITS home Member State under Article 1a(5) by a revised definition of UCITS home Member State based on the criteria of "core administrative function" and applicable law.

To summarize, the proposed solution would be a pragmatic one. It would balance the single markets benefits of full passporting rights with the need to ensure effective fund supervision and oversight. To enable remote management, it would be necessary to relax the requirements of the head office and to harmonize them. However, it should be emphasized that such "relaxation" would be possible only because remote management via the management company passport is an activity regulated under the Directive. Moreover, it should not go so far as to create a letter box entity, which would not fit with the EU regulatory approach to UCITS.

The restrictions that the proposal to maintain "core administrative functions" in the Member State of the fund would imply for the management company passport should not be overstated. It is true that the possibilities offered by remote management (and the activities covered by the management company passport) would be reduced. However, such functions could be carried out via a branch (cf proposed Article 6(4)). Alternatively, the possibility offered to perform such functions via delegation to entities situated in the Member State where domiciliation is sought should give some additional flexibility to the management companies if the management company only wants to use its freedom to provide services.

On the basis of the above solution, two models of UCITS management would become possible under the UCITS Directive (besides self management in the case of the investment companies), at the option of the fund promoter:

1) "Classic UCITS management": as currently, management legally performed by the management company or the investment company in the Member State of the fund²¹ but possibility to delegate the actual/ concrete performance of functions in another Member State or, subject to certain conditions, to a third country (to the exception of the core administrative functions) (Article 5g of the UCITS Directive)

2) "UCITS management performed in the context of the MCP": actual/ concrete performance core administrative functions performed in the Member State of the fund and remaining collective portfolio management functions performed in another Member State by the management company on the basis of the management company passport, but the

²¹ "legally performed" in the sense that the management company or the investment company remain fully liable for the performance of the management function, even if in practice performed by another party in another Member State.

management company remains fully liable for the performance of all functions . In such case, the core administrative functions can be performed by the management company either by way of a delegation, via a branch, or by the investment company itself, as the case may be.

To summarize:

<p>Management of UCITS in a domestic context (fund + management company domiciled in the same Member State)</p>	<p>Management of UCITS performed in the context of the MCP</p>
<p>In the Member State of the fund:</p> <p>All collective portfolio management functions, legally and, where applicable, economically performed by the management company or the investment company.</p>	<p>In the Member State of the fund:</p> <p>No less than the economic performance of the core administrative functions by the management company (by way of a branch or delegation) or the investment company.</p>
<p>In another Member State:</p> <p>All collective portfolio management functions can be economically delegated by the management company or the investment company to third parties (Article 5g of the UCITS Directive).</p>	<p>In another Member State:</p> <p>All collective portfolio management functions can be legally performed and, where applicable economically performed by the management company, to the exception of the core economic functions.</p>

This would have no impact on self-managed investment companies, for which the question of remote management via the management company passport is not applicable.

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<p>Section II Authorization of UCITS <u>Article 4</u></p>	<p>Section II Authorization of UCITS <u>Article 4</u></p>
<p>1. No UCITS shall carry on activities as such unless it has been authorized by the competent authorities of the Member State in which situated, hereinafter referred to as the “competent authorities”.</p> <p>Such authorization shall be valid for all Member States.</p>	<p>1. No UCITS shall carry on activities as such unless it has been authorized by</p> <p>(a) the competent authorities of the <i>its home Member State have approved:</i></p> <ul style="list-style-type: none"> - <i>its instruments of incorporation in the case of an investment company; .</i> in which situated, hereinafter referred

<p>2. A unit trust shall be authorized only if the competent authorities have approved the management company, the fund rules and the choice of depositary. An investment company shall be authorized only if the competent authorities have approved both its instruments of incorporation and the choice of depositary.</p> <p>3. The competent authorities may not authorise a UCITS if the management company or the investment company do not comply with the preconditions laid down in this Directive, in Sections III and IV respectively.</p>	<p style="text-align: right;">to as the “competent authorities”.</p> <ul style="list-style-type: none"> - <i>its fund rules/ trust deed in the case of a common fund/ unit trust;</i> - <i>its choice of depositary,</i> <p>(b) <i>where the UCITS is not a self managed investment company, the competent authorities of the management company’s home Member State have approved its management company, notably its compliance with Section III of the Directive;</i></p> <p>(c) <i>where the UCITS is an investment company, the competent authorities of the UCITS home Member State have established its compliance with Section IV of the Directive</i></p> <p>(d) <i>where the management of the UCITS is performed by a management company located in another Member State pursuant to Article 6(3), such management company has complied with the provisions of Article 6a or 6b.</i></p> <p>Such authorization shall be valid for all Member States.</p> <p>2. A unit trust shall be authorized only if the competent authorities have approved the management company, the fund rules and the choice of depositary. An investment company shall be authorized only if the competent authorities have approved both its instruments of incorporation and the choice of depositary.</p> <p>3. The competent authorities of the UCITS home Member State may not authorise such UCITS if the management company or the investment company do not comply with the preconditions laid down in this Directive, in Sections III and IV respectively.</p> <p>a) <i>such authorities establish that the investment company does not comply with the preconditions laid down in Section IV of the Directive; and/ or, as</i></p>
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<p>Moreover the competent authorities may not authorise a UCITS if the directors of the depositary are not of sufficiently good repute or are not sufficiently experienced also in relation to the type of UCITS to be managed. To that end, the names of the directors of the depositary and of every person succeeding them in office must be communicated forthwith to the competent authorities.</p> <p>[...]</p> <p>3a The competent authorities shall not grant authorisation if the UCITS is legally prevented (e.g. through a provision in the fund rules or instruments of incorporation) from marketing its units or shares in its home Member State.</p> <p>4. Neither the management company nor the depositary may be replaced, nor may the fund rules or the investment company's instruments of incorporation be amended, without the approval of the competent authorities.</p>	<p><i>the case may be,</i></p> <p>b) the competent authorities of the management company's home Member State establish that the management company does not comply with the preconditions laid down in Section III of the Directive.</p> <p>Moreover the competent authorities <i>of the UCITS home Member State</i> may not authorise a UCITS if the directors of the depositary are not of sufficiently good repute or are not sufficiently experienced also in relation to the type of UCITS to be managed. To that end, the names of the directors of the depositary and of every person succeeding them in office must be communicated forthwith to the competent authorities.</p> <p>[...]</p> <p>3a The competent authorities <i>of the UCITS home Member State</i> shall not grant authorisation if the UCITS is legally prevented (e.g. through a provision in the fund rules or instruments of incorporation) from marketing its units or shares in its home Member State.</p> <p>4. Neither the management company nor the depositary may be replaced, nor may the fund rules or the investment company's instruments of incorporation be amended, without the approval of the competent authorities.</p> <p><i>The management company may not be replaced without the approval of the competent authorities of the management company's home Member State.</i></p> <p><i>The depositary may not be replaced, nor may the fund rules or the investment company's instruments of incorporation be amended, without the approval of the competent authorities of the UCITS home Member State.</i></p>
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Explanatory comment

The standard UCITS authorization procedure would need to reflect the possibility to manage UCITS on a remote basis using the management company passport (ie. management of a UCITS by a management company it has designated (in the case of an investment company) or which has set it up (common fund/ unit trust)). It should be made clear that (i) the approval of the fund rules/ trust deed/ articles of incorporation of the fund, as well as the choice of a depositary are under the responsibility of the UCITS home Member State; and that (ii) the approval of the management company is under the responsibility of the management company's home Member State.

In the case of a UCITS managed domestically, the UCITS home Member State and the management company's home Member State would be identical. In the case of a UCITS managed on a remote basis pursuant to Article 6(3), they should be distinguished. The purpose of Article 4 would be to provide for an authorization regime which functions in both cases.

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<p>Section III</p> <p>Obligations regarding management companies</p> <p>Title A</p> <p>Conditions for taking up business</p> <p><u>Article 5</u></p> <p>1. [...]</p> <p>2. No management company may engage in activities other than the management of UCITS authorized according to this Directive except the additional management of other collective investment undertakings which are not covered by this Directive and for which the management company is subject to prudential supervision but which cannot be marketed in other Member States under this Directive.</p> <p>The activity of management of unit trusts/common funds and of investment companies includes, for the purpose of this Directive, the functions mentioned in Annex</p>	<p>Section III</p> <p>Obligations regarding management companies</p> <p>Title A</p> <p>Conditions for taking up business</p> <p><u>Article 5</u></p> <p>1. [...]</p> <p>2. No management company may engage in activities other than the management of UCITS authorized according to this Directive except the additional management of other collective investment undertakings which are not covered by this Directive and for which the management company is subject to prudential supervision but which cannot be marketed in other Member States under this Directive.</p> <p>The activity of management of unit trusts/common funds and of investment companies consists, for the purpose of this Directive, in the functions mentioned in</p>
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II which are not exhaustive. [...]	Annex II which are not exhaustive. [...]
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Explanatory comment

The current drafting of Annex II is not exhaustive. This creates uncertainty. For the purpose of clarification, we propose to remove the reference to the non-exhaustiveness of the annex (see also section on Annex II).

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<u>Article 6</u>	<u>Article 6</u>
<p>1. Member States shall ensure that a management company, authorized in accordance with this Directive by the competent authorities of another Member State, may carry on within their territories the activity for which it has been authorized, either by the establishment of a branch or under the freedom to provide services.</p> <p>2. Member States may not make the establishment of a branch or the provision of the services subject to any authorization requirement, to any requirement to provide endowment capital or to any other measure having equivalent effect.</p>	<p>1. Member States shall ensure that a management company, authorized in accordance with this Directive by the competent authorities of another <i>its home</i> Member State, may carry on within their territories the activity <i>of collective portfolio management and the services</i> for which it has been authorized, either:</p> <p style="padding-left: 40px;">(a) by the establishment of a branch or</p> <p style="padding-left: 40px;">(b) under the freedom to provide services, subject to the provisions of Article 6(4)a.</p> <p><i>If such management company proposes to market the units of the UCITS it manages as provided for in Annex II in another Member State without proposing to carry out any other activities or services, such marketing shall only be subject to the prior requirements of Article 46.</i></p> <p>2. Member States may not make the establishment of a branch or the provision of the services subject to any authorization requirement, to any requirement to provide endowment capital or to any other measure having equivalent effect.</p> <p style="text-align: right;">/...</p>

Explanatory comment

Article 6 should not only provide for the freedom to perform certain activities on the basis of the freedom of establishment or the freedom to provide services, it should also provide for a detailed regime applicable to a management company managing a UCITS on a remote basis under the passport mechanism. This is currently missing in the existing Directive. This is one of the reasons for the failure of the management company passport to date.

The wording of Article 6 should be clarified to confirm that all the activities and services provided for under Article 5, and explicitly collective portfolio management, can be subject to the management company passport (with in the case of remote management performed on the basis of the freedom to provide services, some restrictions linked to proposed new domiciliation rules, cf Article 6(4)a below).

It should also be made clear that a management company wishing only to market the units of the UCITS it manages in another Member State without providing any other activity or service should be subject to the sole provisions of Article 46, not to Article 6a or 6b. This would allow to remove the constraint of the "double notification procedure" created by Article 6b(5), whereby a management company which wishes only to market UCITS units cross-border also needs to go through the management company passport procedure. Even if such constraint has been mitigated from an administrative point of view thanks to CESR guidelines on the UCITS transitional provisions of February 2005²², this should be clarified from a legal point of view. As to what "marketing" should encompass, please see explanatory comment under Annex II below.

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Article 6 (continued)

3. (New) Subject to the conditions set out in paragraph 4 below, UCITS, shall be free to designate, or to be managed by, a management company situated in another Member State, provided such management company fulfils the following criteria:
- (a) It is authorized as UCITS management company in its home Member State in accordance of the relevant provisions of the Directive;
 - (b) It complies with the conditions of Article 6a or 6b.

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²² In CESR guidelines n°04/434b of 3 February 2005 on the transitional provisions of the Directive, available on www.cesr-eu.org, competent authorities of all Member States have agreed from a purely administrative/processing point of view, that all the information foreseen for notification of the management company is to be considered to be fully encompassed in the registration procedure for the product if a management company only wants to market the units of its UCITS in another MS..

Explanatory comment

To fully mirror the freedom for a management company to passport its services via the freedom to provide services or via a branch and for clarification purposes, the freedom for a UCITS to be managed by a management company located in another Member State should be expressly provided for in the Directive²³. In addition, it should be made clear that the management company passport should also be applicable to common funds/ unit trusts. This would also mean that all the functions listed under Annex II can be performed on a remote basis by a management company using the passport procedure, with, in the case of management performed on the basis of the freedom to provide services and because of the proposed new UCITS domiciliation rules (cf Article 1a), some restrictions when it comes to the "core administrative functions" (cf Article 6(4) below) which have to be performed in the Member State of the UCITS²⁴.

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Article 6 (continued)

4. (New) In the case where the management of a UCITS is performed by a management company situated in another Member State pursuant to Article 6(3) above, the following conditions shall apply:

- (a) if the management is performed by a management company on the basis of the freedom to provide services pursuant to Article 6b, such management company shall perform the administrative functions referred to in Article 1a (5) either by way of a delegation to entities situated in the Member State where the UCITS should be domiciled under the provisions of Article 5g or through establishment of a branch in such Member State pursuant to Article 6a. Alternatively and as the case may be, the investment company can perform the administrative functions referred to in Article 1a (5).

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Explanatory comment

Paragraph 4 (a) reflects the new approach on domiciliation proposed in Article 1(a) in the case of the remote management of the UCITS. If a UCITS could be managed on a remote basis, the core administrative functions would have to be performed on the territory of the Member State where the UCITS shall be domiciled, which would imply some restrictions on the passporting of the functions of collective portfolio management listed in Annex II. The purpose of this paragraph is to clarify how these functions could be performed by a

²³ The distinction made between the two scenarios of 6(3)a and 6(3)b results from the existence of a legal personality in the case of an investment company (hence power to designate a management company) and the absence of such legal personality in the case of common funds/ unit trusts (it is the management company which takes the decision to set up and manage a common fund/ unit trust).

²⁴ Cf also explanatory comment given under Article 3 above.

management company located in another Member State: either via a branch or via delegation, or by the investment company itself as the case may be.

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Article 6 (4) (continued)

- (b) only the competent authorities of the management company's home Member State shall be competent to carry out the supervision of such management company;
- (c) the management company shall ensure that, at all times,
 - (i) the UCITS it manages complies with the laws, regulations and administrative provisions in force in the UCITS home Member State,
 - (ii) it provides the depository and the auditor of the UCITS it manages with all information, records and any other data necessary to the performance of their obligations pursuant to the laws, regulations and administrative provisions in force in the UCITS home Member State.

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Explanatory comment

Still in the case of the remote management of the UCITS, Paragraph 4(b) would aim to clarify the division of responsibilities between the competent authorities of the the management company's home Member State and those of the UCITS home Member State. Paragraph 4(b) would clarify that the competent authorities of the management company's home Member State should be competent to ensure its supervision.

Paragraph 4(c) would also make clear that the management company should ensure that the UCITS it manages complies at all times with the law of its home Member State, and that it provides the UCITS depository and its auditor with all necessary information to achieve their mission.

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<u>Article 6a</u>	<u>Article 6a</u>
[...] 4. Before the branch of a management company starts business, the competent authorities of the host Member State shall, within two months of receiving the information referred to in paragraph 2, prepare for the supervision of the management company and, if necessary, indicate the conditions, including the rules	[...] 4. Before the branch of a management company <i>is established and</i> starts business, the competent authorities of the host Member State shall, within two months of receiving the information referred to in paragraph 2, prepare for the supervision of the management company and, if necessary, indicate the conditions, including the rules

<p>mentioned in Articles 44 and 45 in force in the host Member State and the rules of conduct to be respected in the case of provision of the portfolio management service mentioned in Article 5(3) and of investment advisory services and custody, under which, in the interest of the general good, that business must be carried on in the host Member State.</p> <p>5. On receipt of a communication from the competent authorities of the host Member State or on the expiry of the period provided for in paragraph 4 without receipt of any communication from those authorities, the branch may be established and start business. From that moment the management company may also begin distributing the units of the unit trusts/common funds and of the investment companies subject to this Directive which it manages, unless the competent authorities of the host Member State establish, in a reasoned decision taken before the expiry of that period of two months — to be communicated to the competent authorities of the home Member State — that the arrangements made for the marketing of the units do not comply with the provisions referred to in Article 44(1) and Article 45.</p> <p>[...]</p>	<p><i>falling outside the field governed by this Directive</i> in force in the host Member State and the rules of conduct to be respected in the case of provision of the portfolio management service mentioned in Article 5(3) and of investment advisory services and custody, under which, in the interest of the general good, that business must be carried on in the host Member State.</p> <p>5. On receipt of a communication from the competent authorities of the host Member State or on the expiry of the period provided for in paragraph 4 without receipt of any communication from those authorities, the branch may be established and start business <i>notwithstanding the provisions of Article 46.</i> From that moment the management company may also begin distributing the units of the unit trusts/common funds and of the investment companies subject to this Directive which it manages, unless the competent authorities of the host Member State establish, in a reasoned decision taken before the expiry of that period of two months — to be communicated to the competent authorities of the home Member State — that the arrangements made for the marketing of the units do not comply with the provisions referred to in Article 44(1) and Article 45.</p> <p>[...]</p>
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Explanatory comment

It should be made clear that the notification requirements regarding the management company (Article 6a and 6b) and the UCITS product notification (Article 46) are two distinct procedures. Articles 6a (passport via branch) and 6b (passport via freedom to provide services) cover the passport for management companies in relation to the provision of the activity of collective portfolio management and the selected services of Article 5 (as the case maybe). A management company wishing in addition to market its UCITS in another Member State would also have to comply with Article 46. This was already the case with the freedom to provide services in the existing Directive, this should be confirmed when the management company uses the freedom of establishment under the passport procedure. On the other hand, a management company wishing only to market the units of the UCITS it manages cross border (in the sense of Annex II) should only be subject to the product notification procedure

of Article 46 (cf discussion under Article 6(1)). Again, it should be recalled that there is no passport available for the distribution cross-border of non-UCITS under EC law and that the management company passport does not change this situation.

A new reference to the rules "falling outside the fields governed by the Directive" would result from the changes proposed to the approach to notification, as it is sufficient to refer to the field not covered by the Directive instead of Articles 44 and 45.

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<u>Article 6b</u>	<u>Article 6b</u>
<p>[...]</p> <p>5. A management company shall also be subject to the notification procedure laid down in this Article in cases where it entrusts a third party with the marketing of the units in a host Member State.</p>	<p>[...]</p> <p>5. A management company shall also be subject to the notification procedure laid down in this Article in cases where it entrusts a third party with the marketing of the units in a host Member State.</p>

Explanatory comment

This removal would be the result of the proposed new approach to Article 6: it should be made clear that a management company wishing only to market the UCITS it manages in another Member State (in the sense of Annex II) without providing any other activity or service should be subject only to the provisions of Article 46, not of Article 6a and 6b (Cf discussion under Article 6(1) above).

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<u>Article 8</u>	<u>Article 8</u>
<p>1. A depositary must either have its registered office in the same Member State as that of the management company or be established in that Member State if its registered office is in another Member State.</p>	<p>1. A depositary must either have its registered office in the same UCITS home Member State as that of the management company or be established in that Member State if its registered office is in another Member State.</p>
<u>Article 9</u>	<u>Article 9</u>
<p>A depositary shall, in accordance with the national law of the State in which the management company's registered office is situated, be liable to the management company and the unit-holders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them. Liability to unit-holders may be invoked either directly or indirectly through the</p>	<p>A depositary shall, in accordance with the national law of the UCITS home Member State in which the management company's registered office is situated, be liable to the management company and the unit-holders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them. Liability to unit-holders may be invoked either directly or indirectly through the</p>

management company, depending on the legal nature of the relationship between the depositary, the management company and the unit-holders.	management company, depending on the legal nature of the relationship between the depositary, the management company and the unit-holders.
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Explanatory comment

The current rules applicable to the depositary impose that such depositary be located in the same Member State as the registered office of the management company. Articles 8 and 9 should also reflect the case where the management is carried out on a remote basis pursuant to the management company passport, hence where the registered office of the management company is not located in the same Member State as the UCITS home Member State. From an investor protection point of view the depositary should be located in the UCITS home Member State and should be liable to the unit holders in accordance with the rules of the UCITS home Member State. If the investors subscribe to a UCITS located in a given Member State, they should be subject to the investor protection rules of such Member State, which includes supervision rules, depositary regime and investor compensation rules.

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<u>Article 21</u>	<u>Article 21</u>
<p>1. The management or investment company must employ a risk management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio; it must employ a process for accurate and independent assessment of the value of OTC derivative instruments. It must communicate to the competent authorities regularly and in accordance with the detailed rules they shall define, the types of derivative instruments, the underlying risks, the quantitative limits and the methods which are chosen in order to estimate the risks associated with transactions in derivative instruments regarding each managed UCITS.</p>	<p>1. The management or investment company must employ a risk management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio; it must employ a process for accurate and independent assessment of the value of OTC derivative instruments. It must communicate to the competent authorities <i>of the management company's / the investment company's home Member State</i> regularly and in accordance with the detailed rules they shall define, the types of derivative instruments, the underlying risks, the quantitative limits and the methods which are chosen in order to estimate the risks associated with transactions in derivative instruments regarding each managed UCITS. <i>If the management company's home Member State differs from the UCITS home Member State, the management company shall also communicate simultaneously such information to the UCITS home Member State.</i></p>

Explanatory comment

In the context of the UCITS investment policies rules of Section V, Article 21 should be the only provision where the possibility of remote management on the basis of the management company passport needs to be reflected as it relates to the supervision of the management company (the other references to "competent authorities" in Section V being to the competent authorities of the UCITS home Member State). In the context of the supervision of the risk management process to be carried out by the management company (or the investment company, as the case may be), it should be made clear that the only competent authorities should be the competent authorities of the management company's (or investment company's) home Member State, as the case may be. This would reflect the principle set out in the new Article 6(4)c. In the case of a purely domestic UCITS, the competent authorities of the UCITS home Member State and of the management company's home Member State would of course be the same.

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Additional comment

On the basis of the current version of the Directive, it has not been deemed necessary to specify further which competent authorities are responsible for other sections of the Directive, as we believe this might be inferred from the context of each section. It can be assumed that (i) the reference to competent authorities in Section III-IV dealing with management companies/ investment companies, unless otherwise stated, is a reference to the management company's/ investment company's home Member State competent authorities, and (ii) the reference to competent authorities in Sections V to VIII, unless otherwise stated, is a reference to the UCITS home Member State's competent authorities (subject to the amendments proposed under Article 21 above). Finally, Section IX, unless otherwise stated, is applicable to all Member States competent authorities.

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ANNEX II	ANNEX II
<p>Functions included in the activity of collective portfolio management:</p> <ul style="list-style-type: none"> - Investment management. - Administration: <ul style="list-style-type: none"> (a) legal and fund management accounting services; (b) customer inquiries; (c) valuation and pricing (including tax returns); 	<p>Functions included in the activity of collective portfolio management <i>For the purpose of this Directive, the activity of collective portfolio management consists in the following functions:</i></p> <ul style="list-style-type: none"> - Investment management. - Administration: <ul style="list-style-type: none"> (a) legal and fund management accounting services; (b) customer inquiries; (c) valuation and pricing (including tax returns);

(d) regulatory compliance monitoring; (e) maintenance of unit-holder register; (f) distribution of income; (g) unit issues and redemptions; (h) contract settlements (including certificate dispatch); (i) record keeping. - Marketing.	(d) regulatory compliance monitoring; (e) maintenance of unit-holder register; (f) distribution of income; (g) unit issues and redemptions; (h) contract settlements (including certificate dispatch); (i) record keeping. - Marketing Marketing, which, for the purpose of this Annex, shall mean offering for sale, selling and/or delivering units in funds managed by the management company to investors or potential investors
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Explanatory comment

The use of the term "marketing" has created some confusion as there is no definition of such concept in the UCITS Directive. Marketing would need to be defined in the context of the management company passport to clarify the scope of the range of activities authorised under the passport, notably in relation to MiFID. It should be made clear that management companies are able to offer for sale / sell / deliver the units of the funds they manage without requiring any authorisation other than the one to be granted by their competent authorities in relation to the activity of collective portfolio management. They do not need to have any establishment in the host Member State. This results from the original approach of the UCITS Directive under the current Article 44(1). It should also be recalled that this is only possible on a cross border-basis for units of UCITS (cf Article 5(2) first paragraph of the Directive) and that in such case it is also subject to the provisions of Article 46 on notification.

As explained in the section on notification, it does not seem necessary at this stage to give a general definition of "marketing" outside the field of the management company passport.

3. Questions

Legal questions (*section 2*)

1. Does the proposed approach represent the most effective basis for achieving the stated objective (to give effect to the management company passport)?
2. How could the proposed approach be improved? Should alternative approaches be envisaged? Which provisions are not adapted to realisation of the stated objective?
3. Are the reasons for defining the fund and management company domiciles well grounded? Are the proposed criteria and tests for defining the respective domiciles, appropriate and operational? Is the distinction between domicile of fund and that of the management company introduced coherently and systematically in all relevant provisions? Does this distinction need to be reflected more fully elsewhere in the Directive (e.g. depositary responsibilities)?
4. The management company will be able to maintain the shareholder register and assume responsibility for fund valuations for a fund domiciled in another Member State, subject to the provision that these functions be physically performed in the fund domicile (via branching or delegation) and subject to competent authorities of that country. Is this a coherent and operational basis for reconciling the management company passport with the need to ensure sufficient substance in the fund domicile?
5. Are the responsibilities and obligations of the different actors (including depositaries) and competent authorities sufficiently clear so as to ensure integrated supervision of risks at the level of the fund and the management company? Do the strengthened supervisory cooperation mechanisms (cf chapter 6) provide the basis for effective and timely intervention to correct any cross-border supervisory concerns that might arise from exercise of the management company passport?

Economic questions (*section 1*)

6. Do you agree with the analysis of the expected impacts? Are there any other economic or investor protection implications that should be taken into account?
7. Is 'close physical presence' necessary for the depositary to fulfil its duties?
8. What is the annual cost linked to maintaining the two core functions (i.e. valuation and pricing and the maintenance of the unit-holder register) in the fund's domicile? Can significant savings still be achieved despite the performance of those two functions in the funds' domicile?
9. Are there other administrative functions which should stay in the fund's domicile? What would be the estimated additional costs/savings associated to these functions staying in the fund's domicile?