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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

4. Pooling

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1. Assessing the impacts of creating a EU framework for entity pooling

1.1. Background

Proliferation of funds of a small size creates a heavy burden on the fund industry and ultimately investors. Economies of scale are hardly exploitable and inefficiencies via unnecessarily high charges are passed on to investors¹. Increasing fund size through mergers is not the only route to achieve economies of scale. It is neither the optimal one in certain business cases. Local presence may be favoured in some markets in order to better adapt fund features to investors' preferences (e.g. charging structure). In that case asset pooling provides a more appropriate solution. However, entity pooling is ruled out by the Directive's diversification rules and the development of (cross-border) virtual pooling is suffering from a lack of common understanding among regulators.

The White Paper's Impact Assessment (IA) analysis highlights the advantages of creating a more favourable environment for asset pooling. In the case of entity pooling, the White Paper IA report concludes that the UCITS Directive should be changed to allow it. However, no detailed analysis is provided on the scope of this new freedom (i.e. should entity pooling in a broad sense be allowed or should changes to the Directive be limited to allow only the so-called 'master-feeder' structures?) The below option analysis aims at answering that question.

In the case of virtual pooling, the White Paper IA report was less straightforward. It let the door open to the introduction of a common approach. However, further research on this area has led the Commission services to conclude that it does not seem appropriate at this stage to take any measure to create a pan-European environment for virtual pooling. Important cross-liability and other investor protection concerns exist. The use of the technique is not much extended outside a few Member States (MS) and there does not exist so far cross-border virtual pooling experiences. Besides, there are not strong demands on the industry side for such an environment². Analysis of the issues blocking the cross-border development of virtual pooling should be first discussed in appropriate fora. More detail on these considerations is provided in annex.

1.2. Option description

Entity pooling is the technique that allows for the co-management of the assets of different funds through the creation of pools of assets. Those pools are typically collective investment schemes. Participating funds hold units in the pool(s). The value of these units depends on the net asset value of the pool's portfolio. Participating funds enjoy the same economic risks and benefits as if they were directly invested in the underlying assets of the pool.

Savings appear at three different stages: front-office (lower managers' overheads), middle and back-office (lower service-provider fees) and trading execution (more competitive spreads). Since many are achieved at the fund level, they are automatically passed on to investors.

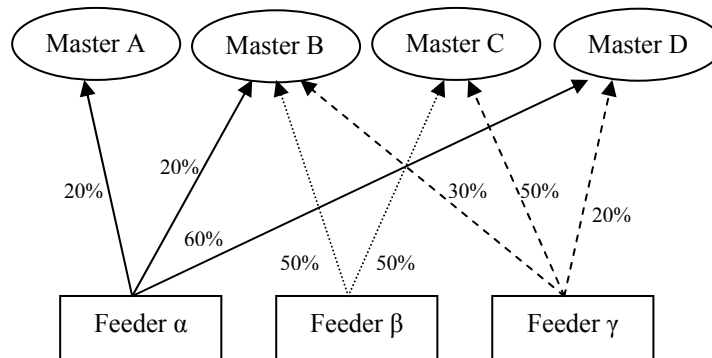
¹ It has been estimated that annual savings of up to 17 b.p. could be attained if European equity fund sizes would converge to that of the average US fund. ("Potential cost savings in a fully integrated European investment fund market", CRA, August 2006.)

² Contributions to the consultations on the Green Paper and the Expert Group report on market efficiency showed a greater interest for master-feeder structures.

There are two options to allow the European fund industry to exploit the savings linked to entity pooling:

Option 1: Allowing entity pooling in a broad sense

Participating funds (or feeder funds) would be allowed to pool their assets into different pools (or master funds).



Pros

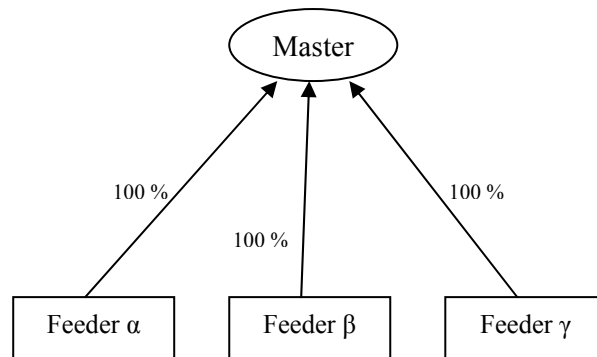
- More flexibility for the manager/promoter of the feeder to tailor its fund to the investor's needs/preferences
- Potential economies of scale

Cons

- Could imply a double layer of fees
- Risk of confusion with fund of fund structures
- If feeders' participations are not fixed (the % in the above graph), every reallocation can mean an important change in the assets of a master and could have negative implications for the other feeders participating in it [e.g. transaction costs]
- More difficult for the supervisor/depositary to monitor a feeder since its investment policy depends on that of different masters. *The problem may be accentuated when the masters are domiciled in other Member State(s)*
- More difficult to administer, particularly from the feeder point of view
- More difficult to understand from the investor point of view
- No or almost no legal provisions for entity pooling in a broad sense at national level that could form the basis for harmonisation at EU level
- No or almost no experience with entity pooling in a broad sense at national level

Option 2: Making master-feeders structures UCITS-compliant

Feeder funds would be allowed to pool their assets (mainly) into an only master fund³.



Pros

- Greater potential for economies of scale than option 1
- Well-known technique by regulators, industry (and investors) with a track record in a number of Member States (MS)
- Allows the use of 'branding' or 'white labelling' techniques⁴
- Easier for the supervisor/depositary to monitor, for the manager to administer and for the investor to understand (than option 1)

Cons

- Less flexibility for the manager/promoter of the feeder to tailor its fund (than option 1)
- Could imply a double layer of fees

1.3. Impacts analysis⁵

Option 1: Allowing entity pooling in a broad sense

A. Efficiency impacts

Implementing option 1 would have the same effect as liberalising the fund of funds regime of the UCITS Directive. The diversification limits imposed by the Directive to these structures (Article 24), in particular, would need to be removed. A UCITS would then be able to invest any percentage in another fund. In order to overcome any concerns derived from this relaxation of the diversification rules, it has been recommended that the feeder and the masters are all UCITS⁶.

The use of this entity pooling technique would allow fund promoters to have access to the best investment managers. Flexibility to tailor feeder funds would allow them to adapt quicker to changing trends. It should also lead to a greater fund choice for the investor.

³ Holding cash and other financial instruments, such as derivatives, is also allowed by various national regimes.

⁴ Investors often manifest preference for products with well-known local brands. By 'white labelling' a fund, this can be sold in different markets with different brand names.

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 Expert Group report on Investment Fund Market Efficiency, July 2006.

On the other hand, supervision by the manager of the resulting structure will require robust compliance monitoring infrastructure. This infrastructure should allow to monitor compliance at two levels: the pools (masters) and the participating funds (feeders). It should then imply higher set-up costs than in the case of a normal fund (or of a fund of funds). On-going scale savings of the structure could compensate those one-off costs. However, potential for scale savings risk being reduced because of the number of pools and the complexity of the structure. A number of working arrangements between feeder and masters may need to be entered into. Performance attribution becomes more complex. It must also be ensured that the evolving portfolios of different masters do not lead to a breach of investment policy rules at the feeder level. Subscriptions/redemptions need to be allocated proportionally and would entail a higher number of operations than in the case of a normal fund or a simple master-feeder structure. In addition, relaxing the diversification requirements of funds of funds structures could be seen as a challenge to the principles underpinning the UCITS Directive.

B. Investor protection impacts

Monitoring of the structure could be simpler if masters and feeders belong to the same group and the management company and depositary are the same⁷. But even in this case supervision by national authorities is more complex and the prevention of operational risks or possible investment policy breaches more difficult.

Important disclosure/financial education efforts may be needed to ensure a correct understanding by the investors of the possible implications of the pooling structure in terms of risks and costs.

Option 2: Making master-feeders structures UCITS-compliant

A. Efficiency impacts

Implementation of option 2 will make possible within the UCITS framework a technique that is already extensively employed at national level in some Member States. Master-feeder structures are used to offer investors access to management capabilities that do not exist 'in-house' (e.g. using 'white labelling'), to adapt products to different investor preferences⁸ or to achieve economies of scale.

Possibility to set-up master-feeders on a cross-border basis will boost the potential for scale savings of these structures. Running costs should be significantly reduced and investors would benefit from this. (As an example of that savings potential, it could be noted that the average Total Expenses Ratio of a Luxembourg fund of assets under US \$ 5 million is more than double than that of a fund over \$ 250 million⁹.)

Compared to option 1, administration would be simpler and scale savings easier to achieve. Continuing cost savings should lead to positive dynamic effects¹⁰ in the long run.

⁷ Otherwise, complex information exchange mechanisms need to be put in place.

⁸ For example, by being able to offer investors the same fund with and without currency risk.

⁹ "Economies of scale and consolidation in collective funds" Lipper, March 2005.

¹⁰ Second round or indirect long-term benefits derived for efficiency improvements at a point in time.

B. Investor protection impacts

Monitoring of the master-feeder structure is facilitated by the fact that both master and feeder have similar, if not identical, investment policies. Establishing timely and regular information exchange mechanisms should not be a problem even where the management companies and depositaries are different. The regulator's role is simpler both at the level of authorisation of the structure and during its on-going supervision.

Proper investor protection requires, however, clear disclosure of the risks and costs associated to the two-layer investment.

1.4. Preferred option

The preferred option is option 2 (master-feeder structures), the potential for savings is higher and investor protection impacts are lesser. Option 1 (entity pooling in a broad sense) has not yet been widely tested at national level and both regulators and many industry players seem wary about it¹¹.

However, implementing option 2 will still require setting a series of requirements in order to minimise any potential supervisory concerns. Requesting that both master and feeders be UCITS should overcome most of them. Obligation to comply with UCITS rules will ensure that feeders' investors enjoy basically the same level of protection as if they were directly invested in the master fund. A co-operation mechanism between regulators should reinforce this protection in the case of cross-border structures.

It should be also noted that the potential tax implications of option 2 have not been explicitly taken into account in the above analysis. The IA report stressed that withholding tax could be an issue as regards entity pooling, in particular for certain pooled structures¹². However, it considered that it was not an argument significant enough not to proceed with the creation of a facilitating framework for entity pooling structures. In any case, investors should be fully informed of the potential tax implications (e.g. in terms of lower returns) that the use of this pooling technique may entail.

1.5. Impact table

| Impacts on → Option ↓ | Efficiency | Investor protection | Preferred option |
|---------------------------------|------------|---------------------|------------------|
| Entity pooling in a broad sense | + | - | - |
| Master-feeder structures | ++ | neutral | X |

¹¹ Support for master-feeders structures have been generally higher than for entity pooling in a broad sense. Please see feedback on the responses to the Expert Group report on Investment Fund Market Efficiency.

¹² For more details please see "Pooling: how can fun managers respond efficiently to different investor needs?", IMA, July 2005.

1.6. Rationale behind other key choices regarding the proposed framework

Regulatory approval: the investment of the feeder UCITS into the master UCITS would need to be approved by the feeder's competent authorities. This approval seems necessary to reinforce investor protection. Competent authorities would verify that a series of arrangements between the feeder and the master (or between their depositaries and auditors) are in place allowing the feeder to fulfil all its duties and, thus, that the protection of investors is not endangered by the two-layer investment.

Minimum investment: Imposing a (high) minimum investment requirement of the feeder into the master should ensure that investment policies are close. This would facilitate the monitoring of the structure and avoid confusion with funds of funds.

Regulators' cooperation: In cross-border structures, it is fundamental that changes affecting the master would be communicated to the competent authorities of the feeder. Otherwise, the resulting supervision gaps risk reducing investor protection.

No delegation of responsibilities: The feeder remains a UCITS even if it has in practice delegated investment management to the master for an important proportion of its assets (minimum 85%). Thus, the investment into a master should not affect the obligations, responsibility and liability of the feeder, or its management company/ depositary. Only then investor protection is preserved.

Information to investors: Making aware investors of the implications, in terms of investment policy and costs, of the two-layer investment is crucial to allow them to make an informed decision before their investment.

2. Shape of possible adjustments to the UCITS Directive¹³

Master-feeder-structures

Title A

Scope and Authorisation

[Scope and principle]

1. Member States shall allow the investment of a feeder UCITS into a master UCITS or an investment compartment thereof, irrespective of whether the master UCITS is situated on their territory or in another Member State, subject to the conditions set out in this Section.

[Definition and investment policy of a feeder UCITS]

2. A feeder UCITS is a UCITS which, notwithstanding Article 1 paragraph 2 first indent, Article 19, Article 22, Article 24 and Article 25 paragraph 2 third indent, invests at least 85 % of its assets in units or shares of one single UCITS ("the master UCITS"). Besides, a feeder UCITS may hold up to 15 % of its assets in:

- (a) ancillary liquid assets in accordance with Article 19 paragraph 4 and/or;
- (b) financial derivative instruments in accordance with Article 19 paragraph 1 lit. (g) and Article 21 paragraph 2 and 3 provided that the feeder UCITS ensures that the aggregate global exposure relating to financial derivative instruments of both feeder UCITS and master UCITS does not exceed the total net value of the feeder UCITS' portfolio and/or;
- (c) movable and immovable property which is essential for the direct pursuit of the business, if the feeder UCITS is an investment company.

[Definition and investment policy of a master UCITS]

3. A master UCITS is a UCITS which has at least two feeder UCITS as unit-holders or shareholders and which does not hold units or shares of a feeder UCITS or of another master UCITS. Notwithstanding Article 1 paragraph 2 first indent and Article 2 paragraph 1 second indent, a master UCITS does not have to raise capital from other investors than feeder UCITS. Provided a master UCITS only raises capital from feeder UCITS in a Member State other than that in which it is situated, neither Section VIII nor Article 52 paragraph 2 of this Directive are applicable.

4. Save as provided for in this Section, feeder UCITS and master UCITS, their depositaries and, where applicable, their management companies, shall have the same obligations and enjoy the same rights as any other UCITS, depositary or management company of a UCITS pursuant to this Directive.

¹³ Provisions on supervisory cooperation are set out in a separate section.

Explanatory comment

[Scope and principle]

The possible adjustments of the UCITS Directive would enable UCITS to make use of master-feeder-structures, both in a cross-border and in a domestic context. A UCITS (the "feeder UCITS" as defined in paragraph 2) may invest all or substantially all of its assets in another UCITS (the "master UCITS" as defined in paragraph 3). Several feeder UCITS may pool their assets in a separate legal entity, the master UCITS, which enables them to profit from economies of scales and to rationalise their management.

Such master-feeder-structures are currently not available for UCITS, as Article 1 paragraph 2 of the UCITS Directive requires UCITS to spread the risks and Articles 22, 24 and 25 paragraph 2 third indent prevent UCITS from investing all or substantially all of their assets in one single UCITS. The possible adjustments would make clear that these restrictions do not apply with regard to feeder UCITS. As the feeder UCITS invests all or almost all of its assets into the diversified portfolio of another UCITS which itself is subject to the diversification rules of the UCITS Directive, the risks of the feeder UCITS are sufficiently spread, though indirectly. Whereas a fund of fund must invest at least into five different sub-funds, a feeder UCITS is only allowed to invest into one single other UCITS, the master UCITS. The ability of a feeder UCITS to invest all or substantially all of its assets into one single UCITS comes along with several specific obligations. Notably, a feeder UCITS would need to be expressly authorised to act as a feeder UCITS of a given master UCITS.

[Definition and investment policy of a feeder UCITS]

The currently envisaged definition of a feeder UCITS defines it as a UCITS with a specific investment policy. First of all, the feeder UCITS must be authorised as a UCITS (which means that it fully benefits from the product passport). Secondly the eligible assets of a feeder UCITS would be strictly limited. A feeder UCITS would, in derogation of Article 19, only be allowed to invest in one single master UCITS and could additionally hold (i) ancillary liquid assets, (ii) financial derivative instruments and (iii), in the case of an investment company, movable and immovable property. A feeder UCITS would not be entitled to invest (neither directly nor indirectly) into any other asset. The envisaged requirement to invest at least 85 % of its assets into the master UCITS shall ensure that the feeder UCITS is investing all or substantially all of its assets in one single master UCITS. On the one hand, this requirement is important to ensure that the investment policies, including the risk profiles, of the master UCITS and the feeder UCITS are sufficiently similar. On the other hand it is necessary to distinguish a feeder UCITS from a fund of funds which is subject to a specific set of rules (see Article 24 of the current UCITS Directive). The remaining up to 15 % of the assets are deemed sufficient to enable the feeder UCITS to hold ancillary liquid assets to ensure the redemption of units at the request of its investors, to use derivatives (in particular to hedge currency risks), and, in the case of an investment company, to acquire movable and immovable property essential for the pursuit of business.

[Definition and investment policy of a master UCITS]

The possible definition would require a master UCITS to have at least two feeder UCITS as investors. Additionally a master UCITS would not be allowed to hold units or shares of (i)

feeder UCITS or (ii) of other master UCITS. A master UCITS would therefore only differ from other UCITS insofar as it would have a specific investor structure.

- As any other UCITS a master UCITS would be entitled to raise capital from the public. Besides feeder UCITS the master UCITS would therefore be able to have institutional and/or retail investors. But in contrast to other UCITS, a master UCITS would not be subject to the requirement to raise capital from the public set out in Article 1 paragraph 2 and Article 2 paragraph 1. A master UCITS would be entitled to choose to have only feeder UCITS as investors.
- Due to its product passport a master UCITS could also be marketed to the public in other Member States pursuant to Section VIII. However, if the master UCITS offers its units or shares in a different Member State to no other investors than feeder UCITS, the current reflections consider to exempt the master UCITS from the rules on cross-border marketing laid down in Section VIII and Article 52 paragraph 2. A notification would have no added value, as the competent authorities of the Member State in which the feeder UCITS are situated in any case would have to authorise the investment of each feeder UCITS into the master UCITS.
- According to the envisaged adjustments the investment of a master UCITS into a feeder UCITS or into another master UCITS would be prohibited. This would avoid opaque cascade structures and protect investors from additional costs associated with further fund layers.

Both the feeder and the master would have to be UCITS and as such would have to comply with the same requirements as any other UCITS. A feeder UCITS would only differ in its investment policy from other UCITS insofar as it would have to invest all or substantially all of its assets into the master UCITS which manages the portfolio. A master UCITS would even more be an "ordinary" UCITS, with the only particularity that some or all of its investors would be feeder UCITS. The depositaries of the feeder UCITS and the master UCITS as well would have to comply with all conditions for depositaries set out in the UCITS Directive. If the feeder UCITS or the master UCITS have a management company, it would be subject to the general provisions applicable to management companies. A feeder UCITS of the contractual type would be obliged to have a fully fledged management company.

*

[Authorisation of a feeder UCITS]

1. The investment of a feeder UCITS into a given master UCITS shall be subject to prior authorisation by the competent authorities of the feeder UCITS. The competent authorities shall grant authorisation if the investment into the master UCITS complies with all the conditions set out in this Section. Reasons shall be given whenever an authorisation is refused.

In the event that the master UCITS has not yet at least one other feeder UCITS as investor as required by *[reference to definition and investment policy of a master UCITS Title A paragraph 3]*, the competent authorities of the feeder UCITS shall grant authorisation only on

condition that at least one other feeder UCITS will later on be also granted such authorisation.

The feeder UCITS may invest into the master UCITS only after its competent authorities authorised another feeder UCITS or after the feeder UCITS provided its competent authorities with an attestation by the competent authorities of another Member State to the effect that the latter authorised another feeder UCITS to invest into the master UCITS. The attestation shall be provided in a language customary in the sphere of international finance. If the feeder UCITS already carried on activities as a UCITS, including a feeder UCITS of a different master UCITS, the feeder UCITS shall be informed within at the latest 15 working days following the submission of a complete file, whether or not authorisation of the investment into the master UCITS has been granted.

2. In the event that the feeder UCITS and the master UCITS are situated in the same Member State, the competent authorities shall grant authorisation if the feeder UCITS, its depositary and its auditor as well as the master UCITS comply with all the conditions set out in this Section. For such purpose the feeder UCITS shall provide the following documents:

(a) the feeder UCITS' and the master UCITS' fund rules or instruments of incorporation or, where applicable, drafts thereof;

(b) the prospectus and the key investor information or, where applicable, drafts thereof, of the feeder UCITS and the master UCITS;

(c) the agreement between the feeder UCITS and the master UCITS referred to in *[reference to Title B - Common provisions for feeder UCITS and master UCITS paragraph 1]* or, where applicable, a draft thereof;

(d) where applicable, the information to be provided to unit-holders or shareholders as referred to in *[reference to Title E Conversion of existing UCITS into feeder UCITS paragraph 1]*;

(e) a declaration of the master UCITS to the effect that it does not hold any units or shares of a feeder UCITS or of another master UCITS and that it has at least one other feeder UCITS as an investor or that at least one other feeder UCITS has applied for the authorisation referred to in paragraph 1, but has not yet been informed by its competent authorities of the decision whether the authorisation was granted or refused;

(f) in the event that the master UCITS and the feeder UCITS have different depositaries, the information-sharing agreement referred to in *[reference to Title C Depositaries paragraph 1]* between their respective depositaries, or a draft thereof; and

(g) in the event that the master UCITS and the feeder UCITS have different auditors, the information-sharing agreement referred to in *[reference to Title C Auditors paragraph 1]* between their respective auditors, or a draft thereof.

3. In the event that the feeder UCITS is situated in another Member State than the master UCITS, the feeder UCITS' competent authorities shall grant authorisation,

(a) if the feeder UCITS, its depositary and its auditor comply with all the conditions set out in this Section and the feeder UCITS for such purpose submits the documents referred to in paragraph 2 of this Article; and

(b) if the feeder UCITS additionally provides an attestation by the competent authorities of

the master UCITS to the effect that the master UCITS is duly authorised as a UCITS, that it does not hold any units or shares of a feeder UCITS or another master UCITS and if it has at least one other feeder UCITS as an investor.

The aforementioned attestation shall be provided in a language customary in the sphere of international finance. The master UCITS' declaration referred to in paragraph 2 lit. (e) shall be translated into the or one of the official languages of the Member State in which the feeder UCITS is situated, or in a language approved by the competent authorities of that Member State. The translation shall be carried out under the responsibility of the feeder UCITS and shall faithfully reflect the contents, be correct, understandable and not misleading.

Explanatory comment

[Authorisation of a feeder UCITS]

As currently envisaged a feeder UCITS would have to obtain a specific authorisation prior to investing into a given master UCITS which means that a feeder UCITS would require an authorisation for its specific investment policy in addition to its authorisation as a UCITS. Such a mechanism would not only enable newly created 'feeder UCITS' to apply for both authorisations at the same time, but also existing non-feeder UCITS to 'convert' into a feeder UCITS.

The competent authorities of the feeder UCITS would have to grant authorisation, if the feeder UCITS and all other involved parties met the conditions set out in this Section. The preconditions for authorisation would be exclusively laid down. The Member States would neither be entitled to require any additional conditions to be met nor any additional documents to be provided. The competent authorities should give reasons whenever the authorisation is refused.

A master UCITS would have at least two feeder UCITS as investors. When a new master-feeder-structure is created, the 'first' feeder UCITS which applies for authorisation would not be able to demonstrate that the master UCITS has already one other feeder UCITS as an investor. To solve this dilemma the competent authorities of this 'first' feeder UCITS should, if all other requirements are fulfilled, grant authorisation on condition that at least one other feeder UCITS will later on be also granted such authorisation, irrespective of whether this 'second' feeder UCITS is situated in the same or in another Member State. This conditioned authorisation would entitle the 'first' feeder UCITS to invest into the master UCITS only after the condition is met, i.e. a 'second' feeder UCITS has been duly authorised pursuant to this Article. If the 'first' and the 'second' feeder UCITS are situated in different Member States, each of them would be able to invest into the master UCITS only after they provided their competent authorities with an attestation of the competent authorities of that other Member State to the effect that the other feeder UCITS has been duly authorised.

For existing non-feeder UCITS which want to convert into a feeder UCITS or for feeder UCITS that intend to change their master UCITS, the competent authorities would be obliged to inform the feeder UCITS on their decision no later than 15 working days following the submission of a complete file. The file is deemed to be complete, if the UCITS provides the documents referred to in paragraphs 2 or 3, respectively.

In a purely domestic context the competent authorities of the feeder UCITS would determine whether all relevant actors (the feeder UCITS, the master UCITS as well as their respective depositaries and auditors) comply with the conditions provided for, whereas in a cross-border context they may only do so with regard to the entities situated in their jurisdiction. In the latter case the feeder UCITS would have to provide an attestation by the competent authorities of the master UCITS which certifies that the master UCITS is a duly authorised UCITS, that the master UCITS does not hold any units or shares of a feeder UCITS or of another master UCITS and if it has at least one other feeder UCITS as investor.

*

Title B

Common provisions for feeder UCITS and master UCITS

1. Member States shall require that the feeder UCITS, prior to investing in units or shares of a given master UCITS, enters into an agreement with the master UCITS which enables the feeder UCITS to meet the requirements laid down in this Directive. Such agreement shall include the following particulars:

- (a) the main characteristics of the master UCITS' investment objective and policy;
- (b) the rules which govern a possible modification of the master UCITS' investment objective and policy; and
- (c) the rights and duties of the feeder UCITS and of the master UCITS and/or of their respective management companies.

2. The master UCITS and each of its feeder UCITS must make public the issue, sale, re-purchase or redemption price of their units or shares simultaneously.

If a master UCITS temporarily suspends the re-purchase or redemption of its units or shares, whether at its own initiative or at the request of its competent authorities, each of its feeder UCITS is entitled to suspend the re-purchase or redemption of its units or shares within the same period of time, irrespective of the conditions laid down in Article 37 paragraph 2 lit. (a).

3. To facilitate the effective operation of the single market and to ensure the necessary protection of investors, the Commission may adopt, in accordance with the procedure referred to in Article 53b, implementing measures specifying how a merger, a demerger, a liquidation or a takeover of or by a master UCITS shall affect the feeder UCITS' authorisation to hold units or shares of that master UCITS and under which conditions the feeder UCITS shall be liquidated as a consequence of an aforementioned event regarding the master UCITS.

Example of possible provisions in relations to events in the life of a master UCITS which could be included at level 2

1. In case of a merger, demerger or takeover

1. *If a master UCITS merges, demerges or is party of a takeover:*
(a) *The feeder UCITS will only be entitled to remain invested into the master UCITS, if the feeder UCITS' competent authorities, following the feeder UCITS' application, grant their authorisation; or*

(b) *The feeder UCITS may redeem all its units or shares in the master UCITS before the effective date of the merger, de-merger or takeover and*

- either invest at least 85 % of its assets in units or shares of another master UCITS subject to prior authorisation by its competent authorities or

- convert into an ordinary UCITS or

- be liquidated.

To enable the feeder UCITS to choose one of the abovementioned options, the master UCITS has to inform the feeder UCITS not less than one month before the proposed effective date of the merger, demerger, or takeover.

2. *No merger, demerger, or takeover affecting a master UCITS may become effective, before the expiry of a delay of [...] for the feeder UCITS to choose one of the aforementioned options or for the competent authorities of the feeder UCITS to grant or refuse authorisation.*

2. In case of a liquidation

1. *If a master UCITS is liquidated, the feeder UCITS shall also be liquidated, unless the feeder UCITS:*

(i) applies for and the competent authorities grant authorisation to invest at least 85 % of its assets in units or shares of another master UCITS or

(ii) converts into an ordinary UCITS.

2. *To enable the feeder UCITS to choose one of the abovementioned options, the master UCITS has to inform the feeder UCITS not less than one month before the proposed liquidation process shall start.*

3. *No master UCITS may start the liquidation process before the expiry of a delay of [...] for the feeder UCITS to choose one of the aforementioned options or for the competent authorities of the feeder UCITS to grant or refuse authorisation.*

Explanatory comment

Common provisions for feeder UCITS and master UCITS

According to the preliminary reflections of DG Internal Market and Services a feeder UCITS would have to comply with certain requirements set up, but it may only do so, if the master UCITS sticks to the stipulated investment objective and policy and cooperates with the feeder UCITS. As a consequence of such dependency, a feeder UCITS may only act in the best interest of its investors if it is in a position to impose on the master UCITS to comply with a certain duties (e.g. regarding the management fees or anti-dilution measures to be taken or to claim damages in case of non-compliance). This may become more complex, if the master UCITS is situated in another Member State than the feeder UCITS. Under such circumstances the feeder UCITS' competent authorities would not be in a position to impose duties on the master UCITS that would enable the feeder UCITS to comply with its own duties.

There are two possible ways to impose such duties on the master UCITS: either by directly setting out a catalogue of duties or by obliging the feeder UCITS and the master UCITS to bilaterally stipulate their respective rights and duties. In the first case the master UCITS' competent authorities would have to supervise the master UCITS' compliance of such duties. In the second case no supervision of the master UCITS' competent authorities is required; only the feeder UCITS' competent authorities would supervise whether the feeder UCITS investors are sufficiently protected by this agreement when authorising the feeder UCITS.

The envisaged option follows the second approach. We believe that the stipulation of rights and duties on a bilateral basis by way of an agreement is not only less burdensome, but also as efficient as the first option. We are convinced that solely the feeder UCITS' competent authorities shall supervise whether the interests of the feeder UCITS' investors are sufficiently protected by the terms of the agreement. This approach avoids creating an additional co-supervision mechanism between the feeder and the master UCITS' competent authorities which would complicate cross-border master-feeder-structures.

The feeder UCITS and the master UCITS shall therefore enter into a legally binding and enforceable agreement. Before authorising the feeder UCITS, the competent authorities of the feeder UCITS would have to check, whether this agreement enables the feeder UCITS to meet the requirements of the UCITS Directive.

As feeder UCITS would have to invest at least 85% of their assets into a master UCITS, the feeder UCITS' performance should either be identical¹⁴ or closely related to the master UCITS'. As the feeder UCITS' subscription or redemption price mirrors the master UCITS' subscription or redemption price, it would be indispensable that the master UCITS and all feeder UCITS make public their subscription or redemption price simultaneously. To avoid arbitrage and speculation no investor should be able to buy or sell units or shares of feeder UCITS on the basis of the already available subscription or redemption price for the master UCITS for the same day. The competent authorities of the master UCITS and of each feeder UCITS would have to safeguard the compliance with this requirement.

¹⁴ If the feeder UCITS invests all its assets into the master UCITS and if we disregard different fee structures.

If the master UCITS temporarily suspends the redemption of its units (irrespective of whether at its own initiative or at the request of its competent authorities) this may have a negative impact on the feeder UCITS. The feeder UCITS nonetheless remains obliged to redeem units at the request of its investors, without being able to at the same time redeem units from the master UCITS. To prevent a massive outflow of funds that might cause a liquidity crisis of the feeder UCITS, feeder UCITS would be entitled to temporarily suspend redemption within the same period of time than the master UCITS, irrespective of whether the preconditions for a suspension of the feeder UCITS pursuant to Article 37 paragraph 2 lit. (a) are fulfilled. Only the competent authorities of the master UCITS may check this.

If the feeder UCITS temporarily suspends the redemption, it may do so only as long as the redemption of the master UCITS' units is suspended. Afterwards it may only prolong the suspension in accordance with Article 37 paragraph 2.

To enable the feeder UCITS to quickly react, the master UCITS' competent authorities would be obliged to promptly inform the feeder UCITS (in a domestic context) or the feeder UCITS' competent authorities, which then have to immediately inform the feeder UCITS (in a cross-border context) of any temporary suspension on the part of the master UCITS. In addition the competent authorities of the feeder UCITS shall ensure that the agreement between feeder UCITS and master UCITS obliges the master UCITS to promptly disclose any decision to temporarily suspend the redemption of its units.

There are also other events regarding the master UCITS that may adversely affect the feeder UCITS and that might even lead the feeder UCITS to be liquidated or to change its master UCITS. The preliminary reflections therefore consider implementing measures that would govern the consequences of a merger, demerger, liquidation, takeover of or by a master UCITS for the feeder UCITS.

*

Title C

Depositories and Auditors

[Depositories]

1. In the event that the master UCITS and the feeder UCITS have different depositories, these depositories shall, prior to the authorisation of the feeder UCITS, enter into an information-sharing agreement which ensures the accomplishment of their duties.

To ensure the uniform application of this paragraph, the Commission shall adopt, in accordance with the procedure referred to in Article 53b, implementing measures specifying the content of such an agreement.

2. The depository of the master UCITS shall promptly inform the feeder UCITS and the feeder UCITS' depository about any irregularities it detected with regard to the master UCITS.

Example of the possible content of an information-sharing agreement which could be included at level 2:

- (a) Time limits and requirement for submitting annual documents, periodical statements, certified inventories, reports on a merger, demerger, takeover, contribution in kind or a liquidations affecting the master UCITS;*
- (a) information about the master UCITS' exposure and*
- (c) information on irregularities of the master UCITS.*

Explanatory comment

[Depositaries]

The feeder UCITS and the master UCITS may choose either to have the same depositary or to have different depositaries. However, the first option is only available if the feeder UCITS and the master UCITS are situated in the same Member State. Due to the fact that the investment of at least 85 % of its assets in the master UCITS creates a strong link between the feeder UCITS and the master UCITS, and in the case where the master UCITS and the feeder UCITS have two different depositaries, the depositary of the feeder UCITS may only comply with its duties if it 'looks through' the feeder UCITS into the master UCITS. The feeder UCITS' depositary may only meet its obligations, if it has timely access to all relevant information and documents. To ensure such timely access, the depositaries of the feeder UCITS and of the master UCITS would have to enter into an agreement which governs the exchange of information and documents. This agreement would be the legal basis for information requests on the part of the feeder UCITS' depositary. When authorising the feeder UCITS, the competent authorities would have to check, whether the information-sharing agreement actually enables the depositaries to comply with their duties. Possible implementing measures could specify the content of such an information-sharing agreement.

Notwithstanding the aforementioned information-sharing agreement, the master UCITS' depositary would be obliged to promptly inform the feeder UCITS and the feeder UCITS' depositary on any irregularities it detected with regard to the master UCITS. Given the strong link between feeder UCITS and master UCITS, this information should enable both the feeder UCITS and its depositary to take the appropriate decisions to protect the interests of their investors (e.g. by obliging the master UCITS to comply with the provisions of the agreement, by claiming damages or by divesting).

*

[Auditors]

1. In the event that the master UCITS and the feeder UCITS have different auditors, these auditors shall, prior to the authorisation of the feeder UCITS, enter into an information-sharing agreement which ensures the accomplishment of their duties.

To ensure the uniform application of this paragraph, the Commission shall adopt, in accordance with the procedure referred to in Article 53b, implementing measures specifying the content of such an agreement.

2. In its audit report the auditor of the feeder UCITS shall take into account the audit report of the master UCITS. The auditor shall in particular report on any irregularities revealed in the audit report of the master UCITS and on their impact on the feeder UCITS.

Example of the possible content of an information-sharing agreement which could be included at level 2:

(a) Time limits and requirement for submitting annual documents, periodical statements, certified inventories, reports on a merger, de-merger, takeover, contribution in kind or a liquidations affecting the master UCITS;

(a) information about the master UCITS' exposure and

(c) information on irregularities of the master UCITS.

Explanatory comment

[Auditors]

The feeder UCITS and the master UCITS could either have the same auditor or different auditors. As the portfolio of the feeder UCITS (mainly) consist of units or shares of the master UCITS, the role of the feeder UCITS' auditor would be slightly different from the role of auditors of "ordinary" UCITS.

The auditor of the feeder UCITS would have to 'look through' the feeder UCITS into the master UCITS' portfolio (i.e. its audit report) when auditing the feeder UCITS. If the master UCITS and the feeder UCITS have different auditors, the feeder UCITS' auditor may only meet its obligations, if it has timely access to all relevant information and documents (particularly the audit report) and may discuss them with the master UCITS' auditor, if need be. To ensure such timely access, the auditors of the feeder UCITS and of the master UCITS would have to enter into an agreement which governs the exchange of information. On the basis of this agreement the feeder UCITS' auditor would be in a position to request information and/or documents that enable it to comply with its duties. When authorising the feeder UCITS, the competent authorities would have to check, whether the information-sharing agreement actually enables the auditors to accomplish their duties. The preliminary

reflections of DG Internal Markt and Services consider implementing measures which would specify the mandatory content of such information-sharing agreement.

As already mentioned, the auditor of the feeder UCITS would have to take into account the audit report of the master UCITS when auditing the feeder UCITS, as at least 85 % of the feeder UCITS' assets consist of units or shares of the master UCITS. If the feeder UCITS and the master UCITS have different auditors, this does not mean that the feeder UCITS' auditor has to audit the master UCITS in order to obtain all relevant information that enable it to audit the feeder UCITS. Instead the feeder UCITS' auditor may rely on the audit report of the master UCITS. In case this audit report reveals any irregularities regarding the master UCITS, the feeder UCITS' auditor has to reflect them in the feeder UCITS' audit report. Furthermore, the feeder UCITS' auditor has to draw conclusions on how these irregularities may impact the feeder UCITS.

*

Title D

Compulsory information and promotional literature by the feeder UCITS

1. In addition to the information provided for in Schedule A, Annex I to this Directive the prospectus of the feeder UCITS shall contain the following information:

(a) a declaration that the feeder UCITS is a feeder of a given master UCITS and as such permanently invests all or substantially all of its assets in units or shares of such given master UCITS;

(b) whether and to what extent the feeder UCITS may additionally invest in assets mentioned in *[reference to Title A Definition and investment policy of a feeder UCITS paragraph 2 sentence 2]*;

(c) a brief description of the master UCITS, its organisation, its investment objective and policy, including the risk profile;

(d) in the event that the feeder UCITS invests into a given investment compartment or a given unit or share class of the master UCITS, also a brief description thereof;

(e) a description of the agreement between the feeder UCITS and the master UCITS pursuant to *[reference to Title B Common provisions for feeder UCITS and master UCITS paragraph 1]*;

(f) how the unit-holders may obtain further information on the master UCITS and the agreement between the feeder UCITS and the master UCITS pursuant to *[reference to Title B Common provisions for feeder UCITS and master UCITS paragraph 1]*;

(g) whether the investment objective and policy, including the risk profile, and the performance of the feeder UCITS and the master UCITS are identical or to what extent and for which reasons they differ;

(h) a description of all remuneration or reimbursement of costs payable by the feeder UCITS by virtue of the investment in the units or shares of the master UCITS as well as on the

aggregate charges of the feeder UCITS and the master UCITS and

(i) a description of the tax implications of the investment into the master UCITS for the feeder UCITS.

The up-dated prospectus of the master UCITS shall form an integral part of the feeder UCITS' prospectus and must be annexed thereto.

2. The up-dated key investor information of the master UCITS shall form an integral part of the feeder UCITS' key investor information pursuant to *[reference to key investor information section, principle and content paragraph 5 lit.(c) (iv)]*.

3. In addition to the information provided for in Schedule B, Annex I to this Directive the feeder UCITS' annual report must also include a statement on the aggregate charges of the feeder UCITS and the master UCITS.

The annual and the half-yearly reports of the master UCITS shall form an integral part of, respectively, the annual and the half-yearly report of the feeder UCITS' and must be annexed thereto.

4. In addition to the requirements laid down in Article 32, the feeder UCITS shall also send the master UCITS' key investor information and prospectus and any amendment thereto, as well as the master UCITS' annual and half-yearly reports, to its competent authorities.

5. A feeder UCITS shall disclose in any promotional literature that it is a feeder UCITS of a given master UCITS and as such permanently invests all or substantially all of its assets in units or shares of such given master UCITS. The feeder UCITS shall refer to its key investor information or prospectus for further information.

Explanatory comment

Compulsory information and promotional literature by the feeder UCITS

In addition to the compulsory information required as an "ordinary" UCITS a feeder UCITS would be subject to specific information duties. This approach takes into account the specific investment policy of a feeder UCITS. As the feeder UCITS is closely linked to the master UCITS, a potential investor of the feeder UCITS is in a position to make an informed investment decision, if this investor:

- is aware of this relationship,
- receives adequate information on the master UCITS and
- obtains all necessary information on the impact of a second fund layer, in particular with regard to charges and taxation.

For that purpose both the prospectus and the key investor information of the feeder UCITS would have to include the additional information as referred to in paragraph 1 or 2.. As the risk profile of the feeder UCITS is identical or closely related to the master UCITS' and as the performance of the feeder UCITS depends mainly on the master UCITS, the additional

requirement that the master UCITS' prospectus and key investor information are integral parts¹⁵ of, respectively, the feeder UCITS' prospectus and the key investor information should ensure that the potential investor can make an informed investment decision. According to DG Internal Market and Services' preliminary reflections implementing measures could further specify the mandatory content of a feeder UCITS' key investor information.

The master UCITS' annual report and half-yearly report would form an integral part of the feeder UCITS' reports and must be annexed thereto as a consequence of the strong link between the feeder UCITS and the master UCITS.

All promotional literature of the feeder UCITS should disclose the fact that it is a feeder UCITS of a given master UCITS.

As the investment of the feeder UCITS into the master UCITS would create a second fund layer and may increase the aggregate amount of direct¹⁶ and indirect¹⁷ charges, the feeder UCITS would be obliged to disclose the aggregate direct and indirect charges for both the feeder UCITS and the master UCITS in its annual report.

Because of the dependency of the feeder UCITS on the master UCITS, the competent authorities of the feeder UCITS could only effectively supervise the feeder UCITS, if they receive not only the feeder UCITS', but also the master UCITS' key investor information and prospectus and any amendments thereto as well as the annual and half-yearly reports.

*

Title E

Conversion of existing UCITS into feeder UCITS

1. In the event that a feeder UCITS already carries on activities as a UCITS, including a feeder UCITS of a different master UCITS, the feeder UCITS shall, prior to investing into the given master UCITS in accordance with [*reference to Title A – Authorisation of a feeder UCITS*], provide not less than 30 days before the date referred to in lit. (c) the following information to all its unit-holders or shareholders:

(a) a statement that the competent authorities authorised it as a feeder UCITS of such master UCITS accompanied by the feeder UCITS' key investor information;

(b) whether it intends to transfer all or parts of its assets to the master UCITS in exchange for units or shares (contribution in kind) or to sell all or parts of its assets and to invest the receipts or parts thereof in units or shares of the master UCITS; in doing so, the feeder UCITS has to disclose all resulting fees, charges and taxes. In the case of a contribution in kind, the

¹⁵ This also means that the feeder UCITS is not only obliged to update its prospectuses, but to also offer or supply up-dated versions of the master UCITS prospectuses.

¹⁶ The term 'direct charges' covers all charges directly paid by the feeder UCITS' investors.

¹⁷ The term 'indirect charges' covers all charges paid out of the assets of the feeder UCITS and not directly by the feeder UCITS' investors.

feeder UCITS has to disclose how the exchange ratio will be determined and which auditor will audit the transfer procedure;

(c) the date when the feeder UCITS will start to invest into the master UCITS and

(d) a statement that the holders have the right to redeem their units or shares free of charge within 30 days. This right shall become effective from the moment the feeder UCITS has sent out the information referred to in this paragraph.

If the feeder UCITS has been notified to market its units in another Member State in accordance with Article 46, the provisions of Article 47 paragraph 1 lit. (b), (d) and (e) shall apply accordingly with regard to the provision of the aforementioned information to its unit-holders.

2. The Member States shall ensure that the feeder UCITS may not invest into the units or shares of the given master UCITS before the period of 30 days referred to in paragraph 1 lit. (d) has elapsed.

3. In the case of a contribution in kind of the feeder UCITS to the master UCITS, the Member States shall require that the net asset value of the transferred assets of the feeder UCITS and the net asset value of the master UCITS be calculated on the transfer date. The exchange ratio shall be determined on this basis. The transfer procedure shall be audited by an auditor.

Explanatory comment

Conversion of existing UCITS into feeder UCITS

Feeder UCITS may either be newly created or already operating UCITS. According to DG Internal Market and Services' preliminary reflections specific rule would be required dealing with the conversion of an already operating UCITS into a feeder UCITS. Such rules would cover (i) ordinary UCITS, but also (ii) existing feeder UCITS which intend to change their master UCITS.

After an already operating UCITS is authorised to convert into a feeder UCITS of a given master UCITS, but prior to the investment into the given master UCITS, the converting feeder UCITS would have to disclose to its investors the information set out in paragraph 1.

The right to redeem free of charge would allow investors to step out, if they are opposed to the feeder UCITS' intended investment into the given master UCITS. To ensure that investors can redeem before the feeder UCITS starts to invest into the given master UCITS, the envisaged approach considers a redemption period of 30 days starting from the sending out of information. The feeder UCITS would not be entitled to invest into the master UCITS, before this period has elapsed.

A cross-reference to the relevant provisions of Article 47 which specifies how investor information to be provided under the Directive, should be provided to investors in another Member States where a UCITS has been notified to market its units would be required. The principle would be that the information should be provided in the manner prescribed by the laws, regulations and/or administrative provisions of the host Member State and in the or one

of the official languages of the host Member State or in a language approved by the competent authorities of the host Member State. The translations are to be carried out under the responsibility of the feeder UCITS.

Paragraph 3 defines the requirements an existing UCITS wishing to convert into a feeder UCITS would be subject to in the case of a contribution in kind. To protect the interests of investors the transfer procedure would need to be audited. The auditor would have to verify whether the net asset values of both the feeder UCITS and the master UCITS have been duly calculated at the transfer date and whether the exchange ratio has been accordingly determined.

*

Title F

Ongoing obligations and competent authorities

[ongoing obligations of a feeder UCITS]

1. The investment of a feeder UCITS into a master UCITS does not affect the obligations, responsibility and liability of the feeder UCITS or, where applicable, of its management company, and of its depositary deriving from this Directive, other community law, national law, the fund rules or the instruments of incorporation towards its investors, the feeder UCITS' competent authorities or any other third party.

In particular, the feeder UCITS and, where applicable, its management company remain obliged to act in the best interest of the investors of the feeder UCITS; in doing so, they have to monitor effectively at any time the activity of the master UCITS.

The feeder UCITS has to ensure that the investment into a master UCITS does not affect its ability to re-purchase or redeem its units or shares at the request of the unit-holders or shareholders or in other cases when this is in the interest of its unit-holders or shareholders.

2. Where a commission is received by the management company of the feeder UCITS, by a director of the investment company or by an employee of either the management company or the investment company, by virtue of an investment in the units or shares of the master UCITS, this commission shall be paid into the assets of the feeder UCITS.

Explanatory comment

Ongoing obligations and competent authorities

A feeder UCITS investing into a master UCITS (and, where applicable, its management company) would not be dispensed from its obligations and its responsibilities.

As the feeder UCITS would remain obliged to act in the best interest of its investors, it would have to monitor the activity of the master UCITS. In doing so, the feeder UCITS would have to ensure that the master UCITS complies with its contractual obligations, but also that the

investment decisions of the master UCITS are in the best interest of the investors of the feeder UCITS.

As the feeder UCITS would have to redeem units at the request of its investors and in other cases when this is in the best interests of investors, the feeder UCITS would have to make sure that it is in a position to do so vis-à-vis the master UCITS. This would not prohibit anti-dilution measures which shall reduce disturbances as a consequence of big redemptions.

Paragraph 2 deals with commissions the master UCITS may receive and may (partly) retrocede to the management or investment company of the feeder UCITS. The management or investment company of the feeder UCITS would be obliged to pay all commissions it has received by virtue of the investment into the master UCITS into the assets of the feeder UCITS.

*

[Ongoing obligations of a master UCITS]

1. The master UCITS must promptly inform its competent authorities of the identity of each feeder UCITS which invests in or which completely divests from its units or shares.
2. The master UCITS may not charge subscription or redemption fees for the feeder UCITS' investment into its units or shares or the divestment thereof.
3. The master UCITS shall ensure the timely availability of all information to the feeder UCITS and to the competent authorities, the depositary and the auditor of the feeder UCITS that is required according to this Directive, other community law, national law, the fund rules or the instruments of incorporation.

Explanatory comment

[Ongoing obligations of a master UCITS]

The master UCITS would be obliged to promptly inform its competent authorities of the identity of each feeder UCITS it receives or loses as investor. It is only on the basis of this information that the competent authorities of the master UCITS are in a position to inform the feeder UCITS or, in a cross-border context, the competent authorities of the feeder UCITS of certain material facts (e.g. regarding decisions or measures taken against the master UCITS).

No master UCITS would be entitled to charge subscription fees when a feeder UCITS invests into a master UCITS or redemption fees when a feeder UCITS divests. This is deemed to be necessary to protect the investors of the feeder UCITS from double-charging.

As any other UCITS, the feeder UCITS would be subject to compulsory information requirements towards its (potential) investors and vis-à-vis its competent authorities. In opposition to other UCITS, the feeder UCITS depends to a high degree on the information it receives from the master UCITS. A feeder UCITS could comply with its duties only if it

receives the required information in due course. For this reason the master UCITS would have to provide the feeder UCITS in a timely manner with all information required by the UCITS Directive or other community law, applicable¹⁸ national law and the fund rules or instruments of incorporation. It would be up to each feeder UCITS to inform the master UCITS of the required information and the relevant time limits. For the same reason the master UCITS would have to provide the feeder UCITS' competent authorities, depositary and auditor with the required information.

*

[Competent authorities]

1. In the event that the master UCITS and the feeder UCITS are situated in the same Member State, the competent authorities shall inform the feeder UCITS without delay of any decision or other serious measure taken, of any observation of non-compliance with the conditions of this Section or of any information referred to in Article 50a paragraph 1 with regard to the master UCITS, its depositary or its auditor.
2. In the event that the master UCITS and the feeder UCITS are situated in different Member States, the competent authorities of the master UCITS shall communicate without delay the information referred to in paragraph 1 to the feeder UCITS' competent authorities in a language customary in the sphere of international finance. The latter shall then promptly inform the feeder UCITS.

Explanatory comment

[Competent authorities]

DG Internal Market and Services envisages certain information duties of the competent authorities of the master UCITS towards the feeder UCITS (in a domestic context; see paragraph 1) and towards the competent authorities of the feeder UCITS (in a cross-border context, see paragraph 2). As the feeder UCITS would have to invest at least 85 % of its assets into the master UCITS, the feeder UCITS would be closely linked to the master UCITS. Therefore, any decision or measure taken by the competent authorities with regard to the master UCITS (e.g. withdrawal of authorisation, suspension of redemption) or with regard to the master UCITS' depositary or auditor would have an impact on the feeder UCITS and its investment into the master UCITS. The same applies in case of non-compliance with the specific requirements established by the competent authorities or the auditor pursuant to Article 50a. It is important that the feeder UCITS receives such information without delay.

In a domestic context (where both feeder UCITS and master UCITS are situated in the same Member State) the competent authorities would have to inform the feeder UCITS without

¹⁸ The master UCITS has to provide each feeder UCITS with the information the feeder is required to furnish to third parties (notably investors and competent authorities) subject to the legal provisions and fund rules/instruments of incorporation applicable to the feeder UCITS. In doing so, the master UCITS has to enable the feeder UCITS to cope with the relevant time limits.

delay on any decision or measure taken or on any observation of non-compliance with regard to the master UCITS, its depositary or its auditor.

In a cross-border context the competent authorities of Member State A may not directly inform the feeder UCITS situated in Member State B. The competent authorities of the master UCITS therefore would have to promptly inform the competent authorities of the feeder UCITS. The latter then has to forward this information to the feeder UCITS.

To enable the competent authorities of the master UCITS to comply with this information duty, the master UCITS would be obliged to disclose the identity of its feeder UCITS' investors to its competent authorities.

3. Questions

Legal questions (section 2)

1. Do you agree/disagree with the intention to harmonise only master-feeder structures? Why?
2. Does the proposed approach represent the most effective basis for achieving the stated objective (to create an effective framework for master-feeder structures)? How could the proposed approach be improved and what alternative approaches could/should be envisaged?
3. Are the responsibilities and obligations of the competent authorities sufficiently clear? Does the proposed authorisation and supervision mechanism ensure an efficient supervision, particularly in cross-border-structures?
4. Do the proposed definitions and scope of the proposed measures adequately capture the main features and characteristics of master-feeder structures?
5. Is the proposed threshold for assets invested in the master by the feeder (i.e. 85%) an appropriate cut-off point? Apart for the (15%) holdings listed as permitted which other instruments/investments should a feeder be allowed to invest in?
6. Are the interests of unit-holders in the feeder UCITS sufficiently safeguarded by the proposed arrangements? Are additional safeguards needed in certain scenarios (e.g. conversion of existing UCITS to feeder UCITS; should master and feeder not be entitled to have the same depositary and/or auditor?)
7. For an investor considering investment in a feeder fund, which are the main elements an investor should be informed about so as to enable her/him to take an informed decision? The resulting investment policy? The resulting level of fees/charges? Others?

Economic questions (section 1)

8. 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?
9. Would the proposed UCITS master-feeder regime have an impact on the number of these pooling structures?
 - Yes, an important surge on the use of master-feeder structures is to be expected.
 - No, the main change will be that existing structures become UCITS-compliant.
 - No, main pooling advantages are already exploited through national structures.
10. Which possibilities could be considered in order to reduce the regulators' and industry's administrative burden and other compliance costs linked to the proposed provisions?

Virtual pooling annex

Definition

Virtual pooling uses information technology to commingle the assets of two or more funds (or sub-funds of an umbrella fund) in a virtual investment pool. However, the investment pool does not constitute an own legal entity. The participating funds remain the legal and beneficial owners of the assets.

Virtual pooling is extensively used in some MS, such as Ireland¹⁹. However, to achieve its full savings potential, some parts of the industry are asking for the freedom to pool fund assets across borders (No cases of cross-border virtual pooling have been accounted for so far.)

Advantages

Virtual pooling achieves savings at three levels. At the front-office, it allows a reduction of managers' overheads. At the middle and back-office, smaller transaction volumes at higher average transaction sizes and fewer trading accounts benefit from lower service-provider fees. Finally, on trading desks, grouped trades face more competitive spreads.

Vis-à-vis entity pooling, since the pool is not a fund, the costs associated to the establishment and maintenance of that 'master' fund are not incurred.

Disadvantages

Virtual pooling relies on efficient accounting systems capable of identifying at any time the assets of each participating fund. This often implies investment in complex IT systems. Part of the economic advantages of virtual pooling could be thus initially foiled. Overtime, the cost of virtual pools is considered to be limited²⁰.

From a supervisor's point of view, the difficulty for virtual pooling structures to segregate assets is a source of concerns. Valuation processes, depositaries' monitoring and regulators' supervision become more complicated. Lack of segregation of assets and interdependency of the funds mean that investment in one participating fund would have repercussions on the performance and costs for investors in other funds within the same structure. Operational risks are also shared among participating funds. For the investor, virtual pooling is less transparent and more difficult to understand.

Barriers

Virtual pooling structures are not prohibited by the UCITS Directive. However, the absence of a common understanding among regulators hinders its cross-border development. Further

¹⁹ Allowed by the IFSRA since 2004.

²⁰ The appendices to the Report on Investment Fund Market Efficiency (July 2006) considered that "in the worst case virtual pooling would involve a premium charge of 4bps. In the best case, it would involve a premium of under one basis point."

hurdles are related to the restrictions to delegate cross-border the safe-keeping of assets. Tax barriers are in general not considered to be an insurmountable problem²¹.

Conclusion

No legislative change is required in order to create a pan-European framework for virtual pooling. Nothing in the Directive impedes the use of that pooling technique. Despite this, the question remains whether the Commission should take any measure in order to create a facilitating environment for virtual pooling. However, the analysis carried out does not find at this stage sufficient grounds to justify such measures, at least in the short-term. Savings appear to be less straightforward than for other pooling techniques, such as master-feeder structures. Important cross-liability and other investor protection concerns exist. The use of the technique is not much extended outside a few MS and no experience with cross-border virtual pooling has been identified so far. Industry responses to consultations show a clear preference for master-feeder over virtual pooling techniques²². Analysis of the issues blocking the cross-border development of virtual pooling should be first discussed in appropriate fora, e.g. CESR (as recommended by the expert group on market efficiency).

The issue could be then revisited by the Commission once there will be a deeper and broader understanding among regulators (but also within the industry) about virtual pooling techniques. In the medium-term, however, one of the White Paper's announced measures could already have a positive impact on the use of cross-border virtual pooling. The planned communication/ recommendation on delegation of custodial functions by depositaries should encourage the possibility to delegate cross-border the safe-keeping of assets and therefore facilitate virtual pooling across borders.

²¹ Please see "Pooling: how can fund managers respond efficiently to different investor needs?", IMA, July 2005 and the pooling annex to the Expert Group report on market efficiency.

²² Please see footnote 2.