

Appendices to the report
on
Investment Fund Market Efficiency

Authorisation, Notification and Simplified Prospectus

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Authorisation, Notification and Simplified Prospectus

Product or Service Passport?

As stated in the report, two alternative solutions were considered by the Group of Experts on how to improve the current situation with regard to authorisation and notification. The first was to model UCITS product authorisation and notification on the Prospectus Directive. The second to rely purely on a collective investment scheme service passport for the operator of the UCITS scheme. Under both options a CA to CA notification would operate as this would be in line with the more modern financial services directives of the Financial Service Action Plan.

A service passport might ultimately result in a faster time to market for the UCITS product once the firm had received its service passport. Without product authorisation, this solution could fit into an enlarged MiFID¹ and is something the Expert Group refers to in the section on the operation of the management company passport. If so, the detailed investment rules that currently apply to UCITS, which detail the eligible assets that a UCITS can invest into, and to what amount, would need to be reconsidered in the light of the level 2 Regulation definition of 'non-complex' product². The ramifications of such a re-write (which would logically extend to amendments to MiFID Level 1 text and which have yet to come into force) are unclear. Furthermore relying on a service passport alone, without any regulatory seal of approval would mean changing the perception of the UCITS brand. For example, a system of self-authorisation might raise issues of compliance with the rules relating to the eligibility of assets – something that has in the past meant home/host CA disagreement and delay and which is being dealt with by additional legislation.

The 20/10 day product approval procedure set out in the Prospectus Directive was not considered to be particularly onerous. Furthermore the Prospectus Directive is more closely aligned, logically, to the UCITS product passport and the regulatory stamp, part of the UCITS brand, would be maintained.

The group's preferred option was to follow the Prospectus Directive. A service passport solution might ultimately result in faster time to market once the firm had received its service passport but that benefit was considered marginal when looking at the current timings for new product listing under the Prospectus Directive.

More importantly, the group felt that the loss of a regulatory stamp of approval, which currently goes some way to define the UCITS brand and which assists operators to sell the UCITS product outside the EU, would not be appropriate at this time.

Implication of the group's proposals

There are a number of implications of this proposal aside from the fact that hard coded change to the Directive will be necessary. These are summarised below.

¹ MiFID categories financial services products as 'complex' or 'non complex' with all products falling into the 'complex' category unless they meet some principled rules (at level 2) on what a 'non complex' product is considered to be. However, MiFID level 1 text clearly categorises UCITS schemes as 'non complex' products.

² The relevant level 2 text prepared by the Commission is currently in the final stages of the Lamfalussy process where agreement is reached between the European Securities Committee and European Parliament.

The Summary Prospectus

The group considered the use of a summary information document to be provided to customers. Although the summary prospectus was part of the Prospectus Directive template there was concern whether any 'upgraded' simplified prospectus should operate in a similar way given the simplified prospectus's failure as a useful document as highlighted in the responses to the Green Paper. The group agreed that an investor should receive some form of up-to-date summary document that explained the benefits, risks and costs associated with their investment and was a valid marketing document in each Member State. However some felt that perhaps the document should fall outside the authorisation/notification process to avoid delays. After some discussion the group gave a guarded agreement for a summary prospectus to form part of the process provided that:

- ◆ as with the Prospectus Directive, it would be a detachable part of the full prospectus (and so clearly a home CA responsibility); and
- ◆ its use as a marketing document should switch off host State marketing rules (i.e. its use, by definition, means product disclosure requirements to the end investor are fully satisfied).

Under the new process, quicker authorisation coupled with additional flexibility in format and content would result in the document being more up to date (addressing a criticism of the current document).

Content of the Summary Prospectus

In terms of content the group supported the approach to provide clear and concise information in a fact sheet format suggested in the recent European Parliamentary Report³. Any contents requirement should be kept at a high level allowing flexibility and up-to-date information. So, for example, audited performance figures should not be a requirement. Also, the addition of information relevant to a specific host state (e.g. local paying agent details or a change in the currency used to quote performance) should be possible (for example by way of an addendum) without the need for re-authorisation by home CA or formal notification to host CA.

The group felt that comparability took second place to readability, though an agreed format and certain standard warnings such as those on liability contained in the Prospectus Directive were acceptable and would mean a certain degree of commonality of design.

Offering vs Giving the Simplified Prospectus

If the obstacles covered in this paper were dealt with successfully the group saw no reason not to give the summary prospectus (as opposed to the current requirement to offer). The group considered that the meaning of 'give' explicitly allows provision of the document electronically and should not result in execution only sales being delayed. Also, a similar requirement as set out in the Prospectus Directive where a fund was only offered to qualified investors should be applied to UCITS funds. This would mean production of a summary prospectus would not be required if the fund was solely aimed at institutional or sophisticated investors (evidenced by the imposition of high minimum subscription amounts).

³ Klinz Report on Asset Management .

Home/Host State competencies

In terms of home/host State residual competencies the group thought that compliance with the summary prospectus should switch off host State marketing rules if the summary prospectus was used for selling purposes (but host State powers would apply to other material and any advertising). However, the group also questioned the operation of administrative rules that are used to delay UCITS marketing. Any amended directive needed to clearly state what was and was not acceptable practise. Similarly the group felt that since notification would be just that, there should only be certain defined cases (such as where a UCITS carries out its own marketing – and does not use an intermediary) where the host CA could charge fees. Some fees are currently levied in terms of basis points on marketing volume which some felt were a type of taxation and not linked to work undertaken.

The group were aware that whilst the Prospectus Directive was operating much more smoothly than the UCITS Directive, there were current concerns over national rules relating to language. Providing a summary prospectus only under the Prospectus Directive when selling to retail clients opened up the seller to potential claims that the purchaser was misled under national consumer protection because the full prospectus was not in an official language of that Member State. The group felt that this interaction needed to be clarified.

Regulator intransigence

The group acknowledged the fact that the timescales envisaged would lead to potential resource issues for regulators. As far as the authorisation timescales were concerned, there would be a commercial imperative on those exporting centres to provide a fast service. Indeed quicker turnaround times exist already under the Prospectus Directive. In addition, importing countries might find that the regulatory focus could shift from the current notification process to perhaps a more focussed monitoring of distribution channels and how products are actually being sold to clients.

Opportunity Cost Considerations

The EFAMA/IMA report on the notification process provides specific details of costs and benefits and the group felt it unnecessary to go into detail on the costs of not carrying out the changes as suggested in this report. In summary the group felt there were four points to emphasise in the new process:

- Reduction of costs – the group believed the new process should reduce costs, in particular registration costs that are currently borne by holders of the fund and which do not appear to add significantly to investor protection.
- Increased competition between UCITS providers – the group believed the new process would encourage new entrants to sell their products cross-border thereby increasing competition which may then have a downward pressure on costs as well as providing increased choice for investors.
- Increase the competitiveness of UCITS products- the group felt the new process would go some way to correcting an anomaly whereby a highly regulated product with the most investor protection characteristics takes the longest time to reach the market.
- Better disclosure to both new and existing investors – as quicker host state notification means that the prospectuses issued in host states will be more up to date.

Group's reaction to Green Paper comments

The Commission green paper responses made a number of arguments in relation to the notification procedure which are set out below together with the group's response

Arguments from the point of view of:	Notification Procedure
Costs	<p>Argument</p> <p>The scope for translation related cost savings is limited. Translations will still be needed. (Not all EU retail investors have a good command of [financial] English.)</p> <p>Response</p> <p><i>Our proposal means the summary prospectus and any related marketing material would need to be translated – this being consistent with the requirements of the Prospectus Directive. However, the sub group considers that the requirements for the fund rules/instrument of incorporation and full prospectus to be translated should be kept to the discretion of the UCITS Management Company or Directors of a 'self-managed' fund. In practise these are not typically used as part of the sales process. If they are there will be a commercial imperative to have translations available.</i></p>
Host country Investors	<p>Argument</p> <p>Necessary to reassure investors that the funds are offered to them in line with investor protection provisions which respect national preferences and tradition.</p> <p>Response</p> <p><i>If the investor protection provisions are that of product approval, the proposed process maintains that requirement. Traditional host State marketing rules would continue to apply but where the summary prospectus was used, the marketing rules would be over-ridden since its form would have already received CA acceptance.</i></p>
Supervisors	<p>Argument</p> <p>Host country authority:</p> <p>(i) Necessary to know what non-domestic funds are being sold in the national market</p>

- (ii) Necessary to ensure compliance with national marketing rules (e.g. ensure that distributors are duly authorised).
- (iii) Necessary in order to check whether the translations are understandable.

Response

- (i) *The host State will still be notified of which product are being sold in the market, it is just that the process will be immediate using up-to-date technology.*
- (ii) *The current UCITS Directive does not ensure compliance with local marketing rules. It ensures that the documents required upon authorisation are translated and filed with the host State. The actual marketing material of the fund is not necessarily pre-vetted by the host State CA.*
- (ii) *We consider that if the translations of marketing material were not understandable they would fail the requirement in the Directive to be 'easily understood' and so the operator would be open to regulatory sanction.*

Argument

Home country authority:

- Necessary to know in which other Member States the UCITS they have authorised is distributed.

Response

We would accept that the notification process would still be a requirement.

Argument

Simplification of the notification procedure will be more effective (its abolition may request a) building into the Directive additional investors' protection provisions which may limit the scope for potential savings or b) a complete harmonisation of regulators practices, which may be difficult to achieve).

Response

We would agree that a more simple notification process is desirable and consistent with other financial services Directives. We are not proposing abolition of a notification process

Other

Argument

Eligible assets' level 2 measures will already reduce considerably authorities' reservations v-à-v other Member States' UCITS. This should accelerate notification procedures.

Response

This argument is reliant on CESR working up proposals on the basis of a pragmatic interpretation of the current translation and notification requirements contained in the UCITS Directive. Our proposal would ensure that accelerated notification would take place on the basis of a proper home State authorisation recognised

immediately by the host State CA.

Argument

Notification provisions enable host country authorities to exercise their residual competencies in the areas not covered by the Directive.

Response

We accept that certain host State residual competencies, which mean host State marketing and facilities rules, should continue to be applied – subject to our point about using such processes to delay marketing. The UCITS Directive needs to focus solely on the product. So, the Directive should only concern itself with distribution matters when the UCITS carries out its own marketing, and even then there should be no need to re-approve the Summary Prospectus and other marketing material.).

Facilitating UCITS Mergers

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A. Definition

Merger means the merger, consolidation, or purchase or sale of substantially all of the net assets between an investment fund (or a series thereof) and another investment fund⁴

A **domestic merger** is a merger between two or more UCITS domiciled in the same Member State

A **cross-border merger** is a merger between UCITS that are domiciled in different Member States.

Note that domestic mergers can still have an impact outside of their Member State, as investors can be domiciled in another Member State. This point is particularly important for tax purposes (see 1.4).

The UCITS Directive does not explicitly state that it is possible to merge investment funds that are domiciled in the same or different Member States. Given this lack of a fund mergers framework, a few asset managers have tried two alternative techniques to accomplish such an operation on a cross-border basis:

- Schemes of arrangement (or amalgamation), where the net assets of an investment fund are transferred separately to another fund. The wind-up of the initial fund occurs at a later stage, once its liabilities have been discharged
- Redomiciliation, involving a move of the registered office of a corporate fund from one domicile to another. A domestic merger is then performed in the new domicile with a different fund

These techniques can be expensive, complex and time consuming, particularly for redomiciliation: multiple General Assemblies and nearly 1½ years for completion, compared to a mere three months for domestic fund mergers. As such, few cross-border mergers of funds have taken place, compared to over 600 domestic mergers since 2003 in the French market alone⁵. A detailed comparison between schemes of arrangement, redomiciliation and « true » cross-border mergers of funds can be found below.

B. Rationale

Despite the fact that the European investment funds market has only two-thirds as many assets as the US market, it has over three times as many funds⁶. This fund proliferation in Europe leads to a relatively high proportion of funds with a higher cost proportional to their size: 4,933 funds with less than € 10 million in assets (or 19% of all funds), and nearly 14,000 funds with under € 50 million in assets (or 54% of all funds)⁷.

Because of this small average fund size, European investors are charged an estimated €2-6 bn more in annual fees than they would if economies of scale could be fully exploited⁸. Removing barriers to cross-border mergers of funds, thereby helping to eliminate these extra costs, could boost fund performance by 5-15 bp per annum.

In addition to potentially being charged more for their fund investments, investors can also be confused by complex fund ranges. The performance of funds run by the same fund provider with similar investment objectives can differ across countries, and investors have to access investment funds in different countries through varying entry points. A single investor holding

⁴ Definition inspired by Rule 17a-8 of the Investment Company Act of 1940, as quoted in Securities Lawyer's Deskbook, University of Cincinnati College of Law, 2004

⁵ Response to Green Paper, Association Française de la Gestion Financière, November 2005.

⁶ US data from Trends in Mutual Fund Investing, ICI, December 2005. European data from Data Digest 2006, FERI Fund Market Information, March 2006.

⁷ Ibid.

⁸ Building of an integrated European Fund Management: Cross border merger of funds, a quick win?, Invesco, January 2005.

funds from the same fund provider that are located in different domiciles could potentially be subject to a multitude of transaction processes (operations and administration).

This complexity and confusion is likely to increase over the next few years, as mergers of financial institutions inevitably result in investment fund duplication and proliferation⁹. Investors and companies alike cannot reap the full benefits of such operations if cross-border mergers of funds are not possible.

C. Barrier inventory

While there is clearly an urgent need to rationalize fund ranges in order to improve market efficiency, merging funds cross-border has been a particularly challenging and expensive exercise to date. The fact that no legal framework exists makes such operations subject to regulatory agreement based on no known and objective criteria. As such, rules applied to cross-border mergers of funds can be different from those applied to domestic mergers, particularly regarding voting and quorum requirements.

Additionally, taxation can be a strong economic disincentive for a cross-border merger of funds. While many Member States have introduced measures to neutralize tax consequences of domestic fund mergers, these do not necessarily apply to cross-border mergers of funds¹⁰. It must be noted, however, that even domestic fund mergers can have negative tax consequences for cross-border customers.

Finally, due to the hindrances mentioned above, the costs associated with the merger can outweigh the savings achieved through economies of scale. Along with legal and other professional fees, there are costs associated with the transfer of assets between funds, as well as providing information to investors.

D. Elements of solution

As cross-border redomiciliation and schemes of arrangement depend upon individual regulator acceptance, they have only been practiced between a limited number of domiciles.¹¹ This leads to discrimination within the European Union, as funds in some countries can be merged cross-border whereas others cannot. This inhibition of free movement of capital within the EU is contrary to the principle of a single European investment funds market, and it also has a large negative impact on this market's efficiency.

While the Expert Group considered referring this matter to CESR for discussion, a lack of existing legislative framework leads us to conclude that this option is not possible. Therefore, it is recommended to immediately start work on implementing a fund mergers framework. During the legislative process, it is also recommended to hold bi- or multi-lateral discussions with individual regulators regarding the possibility to implement schemes of arrangement on a cross-border basis.

- **Scope of a fund mergers regime**

The fund mergers legislative framework should cover all UCITS, including corporate and non-corporate funds¹². This provides equal levels of investor protection, as investors who change fund vehicles as a result of the merger will still be in a UCITS-compliant fund of a similar quality.

⁹ Recent cross-border operations include BSCH's purchase of Abbey and Unicredito's purchase of HypoVereinsbank. It is important to note that domestic mergers of financial institutions often have an impact on cross-border fund ranges as well.

¹⁰ Tax discrimination against foreign funds: light at the end of the tunnel, PwC and EFAMA, November 2005

¹¹ Schemes of arrangement: Ireland -> Luxembourg, UK -> Ireland. Redomiciliation: Belgium -> Luxembourg, Netherlands -> Luxembourg. This list should not be considered exhaustive by any means.

¹² Note that it is currently possible to domestically merge FCPs and SICAVs in France and Luxembourg, among others.

Additionally, it should be possible to merge compartments of umbrella funds, or sub-funds (UCITS III already recognizes the existence of such structures).

Under our proposals, a fund provider who wishes to merge a non-UCITS fund into a UCITS fund would need to convert the former into a UCITS fund in advance of the merger.

- **Legislative framework**

Two potential legislative frameworks exist: as part of the UCITS Directive or as a separate Directive. An Amendment to the UCITS Directive is preferable, considering that this legislation is product-based and the proposed scope of action is all UCITS.

As with the recent Tenth Company Law Directive regarding mergers of joint stock companies (2005/56/EC), a separate Taxation of Fund Mergers Directive should also be put in place (see E.2).

E. Proposed measures in detail

There is no existing language in the UCITS body of law that inhibits fund mergers; rather, the fact that such an operation is not clearly described in the texts prohibits certain regulators from approving cross-border fund mergers. As such, only two articles of the existing UCITS Directive need to be modified, with the remaining text to be placed separately in a new Article.

The proposed merger-related text in the UCITS Directive refers to all mergers (including domestic ones), although it also includes specific provisions related exclusively to cross-border mergers of funds. The nature of the merger – either all fund mergers or simply cross-border mergers of funds- is clearly specified in each provision.

E.1 Modifications necessary to the existing UCITS Directive

E.1.1 Allowing for cross-border fund mergers

Article 1.6 should be amended to include a clause stating that Member States shall provide for mergers of UCITS governed by laws of its Member State with those of another Member State.

E.1.2 Defining cross-border fund mergers

Article 1.a of the UCITS Directive needs to be amended to include a definition of a fund merger.

- (Merger by acquisition) One or more funds, on being dissolved without going into liquidation, transfer all of their assets and liabilities to another existing fund, irrespective of domicile
- (Merger by formation of new fund) Two or more funds, on being dissolved without going into liquidation, transfer all of their assets and liabilities to a fund they form, irrespective of domicile
- (Merger by scheme of arrangement) One or more funds, on being dissolved without going into liquidation, transfer their net assets to another existing fund, irrespective of domicile. The outstanding liabilities of the transferring fund would be discharged at a subsequent time

Note that schemes of arrangement need to be included along with « true » mergers, as the former technique could be preferred for mergers of funds with a different legal form in certain Member States (ex : unit trust and OEIC).¹³

E.1.3 Role of regulators in cross-border mergers of funds

It is necessary to refer back to Articles 49 and/or 50 to invoke the mutual cooperation between regulators. The regulatory role in cross-border mergers of funds should be divided as follows :

- Each regulator will obtain appropriate information regarding the merger concerning the fund in their jurisdiction that is subject to merge. Demands for information should not be materially different from what is required for a domestic fund merger
- The regulator of the fund that will no longer exist after the merger (the « merging fund ») will approve the merger and statue on the merger's completion. This is the opposite from Company Law, as it is important to ensure that the investors who will change from one fund to another are correctly protected. Should the merger involve more than one merging fund, and such funds be domiciled in different Member States, it is understood that the regulators of such funds will cooperate (as mentioned above) to statute jointly on the merger's completion
- As with the Tenth Company Law Directive, either regulator can disapprove the fund merger if it would be possible to do so for a domestic fund merger on similar grounds

E.1.4 Valuation of assets and determination of the exchange ratio

An independent auditor would be needed to audit the valuation method of the assets and the exchange ratio in all fund mergers. The depositary (or depositaries, if more than one) will then be responsible for the asset transfer according to one of the methods specified in E.1.2, and will also conduct a verification of the asset value.

E.1.5 Notification in fund mergers

In order to provide appropriate investor protection in all fund mergers, the fund that will exist post-merger (the « receiving fund ») should be registered for sale in all of the EU/EEA countries where the merging fund is registered prior to the effective date of the merger. Any EU/EEA registrations established prior to the beginning of the merger process should stand, both during the process and after the effective date of the merger.

E.1.6 Investor information

Investors should receive a document in at least one of the official languages of their Member State or a language approved by the competent authorities of their Member State that contains the following information prior to all fund mergers :

- Comparison of investment policy between the merging and receiving funds. If the merger would effectively result in a change in the investment policy for investors in the merging fund, concurrent approval of such a change in investment policy would need to be explicitly obtained.¹⁴ However, this would only imply a vote if required by local law. Rather than

¹³ In France, the merger of any two funds – including an FCP and a SICAV - involves two simultaneous operations (fusion-absorption). As such, the transferring fund ceases to exist immediately following the merger. This is not the case in all Member States, as sometimes the transferring fund is liquidated at a later time.

¹⁴ Note that this is consistent with Rule 17a-8 of the Investment Company Act of 1940, as amended. Under this Rule, a vote must be conducted to the extent to which a policy is « materially different » due to the merger.

requiring unanimity for such a change, as is currently the case in Member States such as Germany, the emphasis is on appropriate disclosure to investors

- Comparison of charges between the merging and receiving funds
- Description of the asset valuation and exchange ratio, as well as the method used to transfer assets
- Offer to provide the summary prospectus of receiving fund, plus email link to the most recent annual report of receiving fund (provided that such a document exists)
- Detailed information on voting process where relevant, including information regarding exit scenarios for dissenting investors without charge or penalty

The documents submitted to investors will have been submitted to the appropriate regulator involved in the fund merger prior to their distribution.

E.1.7 Voting in cross-border mergers of funds

Each fund involved in a cross-border merger will follow the voting procedure as required by its local jurisdiction. Where voting is required by local law, quorums and/or thresholds should not be overly onerous and in no cases should be more than 75% of those voting. A detailed comparison of current voting practices in selected fund domiciles can be found below.

The Expert Group recommends a harmonization of voting practices across the EU in Member States where voting is required, even though this could potentially require changes to company law.

E.1.8 Performance history, track record and name

Extensive industry initiatives have already been put in place regarding performance history, track record and name, notably under the leadership of EFAMA. Legislation regarding these points should not be necessary.

E.2 Taxation of Fund Mergers Directive

The Taxation of Mergers Directive (90/434/EC) provides exemption from additional tax in cross-border mergers of joint stock companies. Similarly, a Taxation of Fund Mergers Directive is needed to ensure that UCITS to UCITS mergers have no adverse tax implications, be it for taxation of investors, funds or investments held within a fund. As shown in the attached analysis, special provisions need to be included in such a Directive for the following issues :

- Capital gains on investors
- EU Savings Tax Directive-related taxes paid by investors¹⁵
- Stamp duties paid by funds on their investments in EU domiciles such as the UK

The Taxation of Mergers Directive (90/434/EC) includes language that can be used to solve the first two issues, and the third issue requires an exemption provision within the new Directive.

Whereas the aforementioned Taxation of Mergers Directive only applies to mergers of joint stock companies established in different Member States, the proposed Taxation of Fund Mergers Directive would need to apply to all mergers of UCITS. This is required in order to provide investors with the same level of protection in both domestic and cross-border mergers. Such a Directive would principally benefit investors, as they suffer the greatest tax-related consequences from fund mergers, either directly or indirectly.

¹⁵ Note that operational issues under the EU Savings Tax Directive for mergers should be solved by the industry.

As stated above, investors involved in a domestic merger could potentially be domiciled in a different Member State to the fund. Since such a merger could potentially be considered to be a taxable event for these investors, it is important to include domestic mergers along with cross-border mergers in the Taxation of Fund Mergers Directive.

Finally, the Expert Group recommends that the NAV of Italian funds be quoted gross of tax to individuals, as is largely the case throughout the EU. Should Italian funds continue to calculate their NAVs net of tax, they will be discriminated against in cross-border mergers of funds.

F. Possible supervisory/investor protection objections and other drawbacks

Many of the arguments against cross-border fund mergers evoke the necessity to develop national ranges, which presumably would cease to exist should cross-border fund mergers become possible. To the extent to which national preferences are not homogeneous across the European Union – and probably never will be – domestic ranges will continue to flourish. Cross-border mergers will most certainly not stop new fund launches, either in domestic or cross-border fund ranges, but they will help increase cost efficiency by removing funds that no longer have a clear commercial purpose.

An additional specious argument against cross-border fund mergers concerns the fact that mergers are not even taking place within national borders. Nearly one-quarter of all funds were merged/closed over the past three years as the result of almost exclusively domestic fund mergers¹⁶; however, this is insufficient to achieve full economies of scale in an industry that is increasingly European, if not global.

Investor protection is an important point, and the Expert Group has spent a long time considering this issue. Within the proposed framework, investors in UCITS have the following rights :

- The right to adequate information regarding the merger
- The right to exit without charges should they not wish to participate in the merger
- The right to not suffer undue taxes because of the merger (to the extent that this is possible, given the wider variety of investor types and domiciles in an internationally distributed fund)
- The right to continue to own a UCITS-compliant fund after the merger
- The right to hold a fund that is notified for sale in their country after the merger (assuming that was the case for their original holding)

The apportioning of the regulatory responsibilities also helps to ensure investor protection, as the regulators involved scrutinize all fund mergers. Additionally, the regulator of the merging fund is responsible for determining the completion of the merger. For the regulators, a tax neutral framework should eliminate any possibility of arbitrage. A clear definition of the regulatory responsibilities in the execution of the merger should also help assuage any fears of complex supervision of the merger operation.

¹⁶ Data Digest 2004 / 2005 / 2006, Feri Fund Market Information, April 2004 / March 2005 / March 2006

G. Pre-requirements, mitigating measures, savings sharing

Fund mergers confer extensive benefits on investors, who can benefit from increased investment choice, given potential inclusion of funds within umbrella structures that have favourable switching arrangements, as well as facilitated fund selection, since product ranges would be clearly presented and more relevant. Investors would have access to funds with consistent management performance available across different countries, and funds would be able to fully take advantage of available economies of scale, as shown by average TERs¹⁷. Finally, investors would have simplified operations and administration, as they would access mutual funds through a unique entry point.

Most importantly, these investors still maintain the high level of protection and product quality associated with UCITS that they experienced prior to the merger.

H. Feasibility and costs identification

As mentioned above, implementing the fund mergers framework requires amending the UCITS Directive and passing a related Taxation of Fund Mergers Directive. Once these are in place, it should be relatively simple for investment companies to conduct cross-border fund mergers and realize the afferent cost efficiencies. The relevant benefits should then be conferred directly onto investors in such investment funds for the reasons mentioned above.

I. Other possible solutions

It is clear that a fund mergers framework should be put in place as quickly as possible in order to improve the cost efficiency of the investment funds market.

A significant debate has centered around the utility of cross-border fund mergers should pooling be enabled on a cross-border basis. These two techniques are complementary and should be considered as such. Some investment companies would prefer to implement cross-border pooling techniques, potentially maintaining (more cost-efficient) multiple fund ranges for marketing reasons, whereas others would prefer to consolidate investment funds across borders. The mergers versus pooling decision is related to investor preferences and choice of business model, but a decision to begin work on one framework should have no consequence on the other framework.

¹⁷ Lipper / Fitzrovia, September 2005 and “Report on mutual fund fees and expenses”, Securities and Exchange Commission, December 2000.

Types of fund mergers

	<u>« True » Mergers</u>	<u>Schemes of Arrangement</u>	<u>Redomiciliation</u>
Pros	No legacy liabilities Shorter process Higher clarity for investors Applicable to corporate and non-corporate funds	Currently possible subject to regulatory approval of technique	Currently possible subject to regulatory approval of technique
Cons	Political issues regarding potential fund concentration in one domicile, but UCITS provides equal protection across Europe	Not possible where non-corporate funds not recognized or subscription in specie not possible Inefficient and expensive process Need provisions for liabilities in initial domicile	Cannot apply to non-corporate funds Questions as to continued legal personality of entity Lengthy process with many General Assemblies and onerous voting Inefficient and expensive process
Implications	EU Legislative modification	Legislation to allow subscription in-specie in some domiciles Legislation in countries not allowing technique	Legislation in countries not allowing technique

Source: Expert Group. All information herein is not warranted as to completeness or accuracy and is subject to change without notice.

Mergers of Domestic Funds in Luxembourg – Individuals

Tax Domicile of Investor	Fund Wind-up	Fund Merger (SICAV to SICAV)	Fund Merger (FCP to SICAV)	Sub-fund Merger (same SICAV)	Sub-fund Merger (Different SICAV)
Belgium	Gains taxed; not off-settable against other losses; losses not off-settable against other gains	Rollover	Unclear	Rollover	Rollover
France	Gains taxed @ 26% offsetable against other similar losses; similar losses offsetable against present and future gains (5 years)	Rollover	Rollover	Rollover	Gains taxed @ 26% offsetable against other similar losses; similar losses offsetable against present and future gains (5 years)
Germany	Taxable (complex)	Taxable (complex)	Taxable (complex)	Taxable (complex)	Taxable (complex)
Italy	Gains taxed @ 12.5%; not offsetable against other losses; losses not offsetable against other gains; rollover if re-invested in another fund of same SICAV	Rollover	Gains taxed @ 12.5%; not offsetable against other losses; losses not offsetable against other gains.	Rollover	Gains taxed @ 12.5%; not offsetable against other losses; losses not offsetable against other gains.
Spain	Rollover if re-invested in another fund	Rollover	Rollover	Rollover	Rollover
Switzerland	Rollover, but 0.15% stamp duty on broker deals; taxable in some cantons	Rollover, but 0.15% stamp duty on broker deals; taxable in some cantons	Rollover, but 0.15% stamp duty on broker deals; taxable in some cantons	Rollover, but 0.15% stamp duty on broker deals; taxable in some cantons	Rollover, but 0.15% stamp duty on broker deals; taxable in some cantons
UK	Gains taxed @ 40%, offsetable against other losses; losses offsetable against present and future gains	Rollover (assuming both funds have UK distributor status)	Gains taxed @ 40% (income tax); losses offsetable against other gains, but as our FCP is non distributing, gains not offsetable against other losses	Rollover (assuming both funds have UK distributor status)	Rollover (assuming both funds have UK distributor status)

Source: Tax Law, as researched by Expert Group. All information herein is not warranted as to completeness or accuracy and is subject to change without notice.

Voting Procedures for Domestic Mergers of Corporate Funds

Country	Can investors vote ?	Quorum ?	Voting Threshold ?
Belgium	Yes	1 st Meeting : At least 50% capital 2 nd Meeting : At least 1 unitholder	Minimum 75% of votes
Finland	No	--	--
France	Yes	1 st Meeting : At least 33% capital 2 nd Meeting : At least 1 unitholder	Minimum 50% of votes
Germany	No	--	--
Italy	No	--	--
Luxembourg	Yes	1 st Meeting : At least 50% capital 2 nd Meeting : At least 1 unitholder	Minimum 66% of votes
Spain	Yes	1 st Meeting : At least 50% capital 2 nd Meeting : At least 25% capital	Minimum 66% of votes if <50% capital ; Minimum 50% of votes if >50% capital
UK	Yes	1 st Meeting : At least 2 unitholders 2 nd Meeting : At least 1 unitholder	Minimum 75% of votes

For information :

US	Yes	At least 50% capital	Lesser of : - Minimum 2/3 votes (if quorum reached) - Minimum 50% capital
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Source: Company Law, as researched by Expert Group. All information herein is not warranted as to completeness or accuracy and is subject to change without notice.

Taxation of Fund Mergers

Types of fund taxation	Example	Tax problems with mergers	Solution
Taxation of investor	Tax on income	Not an issue for mergers	
	Tax on gains	Main tax obstacle to mergers (e.g. see earlier chart for Lux)	Use art 8.1 1990 taxation of mergers directive
	Stamp duties on unit transfers	e.g. Switzerland, but not EU	Not EU – out of scope
	EU taxation of savings directive	Withholding on bond and money market fund mergers	Solution: Covered by 8.1 again, but does not apply to non-EU paying agents Separate share classes needed for TIS calculations (industry solution)
Taxation of fund	Taxe d'abonnement in Lux	Not an issue for mergers	
	UK SDRT/corporation tax	Does not appear to be a problem	
	12.5% tax in Italy		Roll-over needed for Italy - complicated
Taxation of investments	Stamp duties	<u>EU</u> UK - exemption on case by case Ireland Poland <u>Non-EU</u> Hong Kong	Exemption provision from directive required Non-EU out of scope
	Withholding taxes	Not an issue for mergers	
	Capital gains taxes e.g. India	Not an issue for EU investments Non-EU out of scope	

Source: Tax Law, as researched by PwC and Expert Group All information herein is not warranted as to completeness or accuracy and is subject to change without notice.

Commingling techniques

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Recommendations (Pooling for UCITS)

1. The UCITS Directive should be amended to allow Designated Commingling Structures (DCS) as harmonised European funds.
2. Designated Commingling Structures under an amended UCITS directive should be subject to the following conditions :
 - The UCITS fund wishing to commingle its assets into another UCITS must be designated as a Designated UCITS Commingling-Out Fund (DUCOF) investing into at least one designated UCITS (DUCIF)
 - Both DUCOF and DUCIF must be a UCITS fund
 - DUCOF may invest up to 100% of its gross assets into the DUCIF with no minimum investment
 - the named Investment Manager of the DUCOF must be the same entity as the named investment Manager of the DUCIF, or, the named Investment Managers of the DUCIF and DUCOF must belong 100% to the same asset management group or under “common control” of a single group
 - The investment limits under Article 24 of UCITS III with respect to diversification should be amended to apply only to the assets of the DUCOF which are not invested in a designated DUCIF
 - All other requirements of Article 24 of UCITS III continue to apply
 - DUCIFs may not invest in DUCOFs within the same structure
3. Appropriate disclosure requirements should apply to Designated Commingling structures including in particular fee arrangements between the DUCIF and DUCOF.
4. Appropriate mechanisms should be in place to ensure no “double-charging” of fees to DUCOFs, following the example of existing UCITS III provisions allowing UCITS funds to invest in other UCITS funds.
5. The UCITS III Directive should be clarified or amended to allow the appointment by the Depository of a global sub-custodian based in the EU under its responsibility.
6. The European Commission should propose CESR as a venue for national regulators to discuss pooling in its different forms, for the purpose of educating regulators, define legitimate issues and concerns, and develop guidelines for UCITS pooling structures.

continued...

Pooling for Investment-Funds (continued)

Recommendations (Pooling for UCITS) *(continued)*

7. The European Commission should give CESR a comprehensive mandate, equivalent to a Level III review in the Lamfalussy process, to examine and, where appropriate, to clarify and/or to develop guidelines for the following questions in relation to virtual pooling :
 - confirm that virtual pooling falls within possibilities of current UCITS III directive
 - confirm independence of investment and accounting policies of investment funds participating in a pooling structure
 - confirm that duties of the named Investment Managers and named Depositories of investment funds participating in a pooling structure remain unchanged
 - clarify accounting and valuation principles in pooling mechanism
 - confirm that the quality of ownership of assets remains unchanged and, if appropriate, develop conditions to ensure that such is the case
 - clarify potential dilution effects on investment funds participating in a pooling structure
 - confirm requirements for counterparty identification for joint trading accounts
 - clarify disclosure requirements
 - identify concerns around operational risk and measures to mitigate such risk

Recommendations (Pooling for Pension Funds)

1. CEIOPS should review Member States' transposition of the Occupational Pensions Directive to confirm that pooling is, indeed, permissible, but, other things being equal, it would appear to be so.
2. The European Commission should co-ordinate Member States' representation on OECD Working Party No 1 on Tax Conventions and Related Questions, and propose a basis for international mutual recognition of fiscally transparent entities.

Pooling for Investment-Funds

A. Scene Setting

Pooling (better known as commingling) techniques implies the ability to combine asset into a common account for the purpose of investment management and custody.

For investment funds, it implies the ability to manage on a combined basis assets from several accounts combined into one account for this purpose. Specifically, it implies for essential functions required for the purpose of combining assets into one account:

- to trade with the market on behalf of these accounts,
- to allocate executed market trades to these accounts,
- to change ownership of the combined assets dynamically, either through a unitisation or rebalancing process, among participating accounts, as each account contributes to or withdraws cash from the combined assets.

Past industry experience

Pooling structures for UCITS funds are widespread in the cross-border domiciles of Luxembourg and Dublin today. They have been around since 1997, pioneered in Luxembourg.

They are known and accepted by EU regulators of host-country markets and carry appropriate disclosures in the related prospectuses.

The accounting concepts in pooling are straightforward and no more complex than the accounting required of a straightforward investment fund. However, the technology required can be more complex, in particular in the case of virtual pooling.

In the UCITS space, the benefits of pooling have been limited to date to funds in the same domicile. To achieve the full benefits of pooling, pooling on a cross-border basis, involving UCITS funds from different domiciles, is necessary.

The analysis and recommendations in this report will focus on four different situations of commingling shown below.

“Entity Pooling” refers to commingling, including the three essential functions outlined above, achieved by combining the assets into a separate legal (fund) vehicle. An example is a Master Feeder structure, or a pension pooling vehicle in the European cross-border fund domiciles. Legal ownership of the assets is vested in this entity. The process of dynamic ownership of the assets is achieved through unitisation.

“Entity Pooling” is an “n to N plus Own” relationship where the investing funds (n) are investing into any number of target funds (N), but may hold their own assets (Own) in addition to their holdings in the target funds.

“Virtual Pooling” refers to a commingling, including the three essential functions outlined above, achieved by combining the assets into a separate account but not into a separate legal vehicle. Legal ownership of the assets remains with the participating accounts. The process of dynamic ownership of the assets is achieved through “rebalancing” proportionately to the contributions and withdrawals by the participating accounts.

Similar entity pooling, virtual pooling is an “ n to N plus Own ” structure where the investing funds or accounts are investment into any number of target pools (N), but may hold their own assets (Own) in addition to their holdings in the target pools.

Fund of Funds

It is worth mentioning that while some forms of commingling, such as entity-pooling, can lead to pseudo fund-of-fund structures, this is not the objective *per se*.

The objective of fund-of-funds structures is to outsource product infrastructure and investment management (ie manufacturing) to other providers (ie to other manufacturers).

Thus, fund-of-funds is an n-N relationship whose primary characteristic is that the target funds (N) are products of other asset managers.

The objective of pooling is to take allow manufacturers to achieve a lower cost-of-manufacturing by allowing them to commingle their products for the purpose of investment management, thus achieve manufacturing savings. This does not equate to outsourcing, but rather to internal rationalisation of some manufacturing functions.

Thus, fund-of-fund structures do not share the same objective as pooling structures. In addition, fund of fund structures raise additional questions in the eyes of regulators due to the fact that the choice of target funds is open.

Master-Feeder Structures

Master-Feeder structures are commingling structures where a specific fund (Feeder) is created for the purpose of investing the entirety of its assets into one specific fund (Master). This is a “1 to 1” relationship. The master holds and invests the underlying assets. As such they are two-tiered structures in which the Feeder is designed to provide access to a specific investor segment, which, for one reason or another, the master is unable to access efficiently.

While commingling is inherent to the Master-Feeder structure, the prime purpose of the Master Feeder is to obtain better market access to an existing structure, not commingling *per se*.

In any discussion on commingling in a future UCITS context, it should be borne in mind that fund sponsors and asset managers view cross-border Master-Feeder structures as part of the commingling toolbox that should be enabled.

Other forms of commingling

Multiple share-classes are in widespread use in the cross-border UCITS domiciles (Luxembourg and Ireland). They avoid the establishment of an additional fund or account layer, and the technology and know-how available to account for share-classes is also widespread, at least in the cross-border domiciles. Non-base currency share classes are also widespread. On-shore domiciles are only now beginning to allow funds with multiple-class structures.

The purpose of multiple-class structures is to attract additional segments with different requirements, mainly in the area of fund expenses, distribution commission, base currency, or currency exposure requirements. Here too, the prime motivation is access to additional investor segments.

In principle, multiple share-class structures require less incremental cost than commingling structures involving an additional fund or account layer.

However, there are limitations to multiple share-class structures due to their nature. It is not always possible or desirable, for a number of technical, legal or business reasons, to use the same fund product to attract specific investor segments: a separate fund product is required.

Current forms of pooling and commingling

	Investment funds (UCITS)	Pension Funds
Entity pooling	Multiple-class structures Domestic Master-Feeder Structures (France, Luxembourg)	Pension pooling vehicles with tax-transparent structures - Luxembourg FCP - Ireland CCF - UK PFPV
Virtual Pooling	Commingling through UCITS and non-UCITS pooling structures now common in cross-border domiciles (Luxembourg and Ireland)	Pension accounts commingled through virtual pooling (no known examples)

The various forms and scenarios of pooling in the current European context

B. Rationale

Purpose of commingling : combined asset-management of assets of multiple accounts as one “pool” – on a cross-border basis

All commingling arrangements are established for the ultimate main purpose of managing assets as one combined pool, as opposed to managing multiple assets accounts. Examples are multiple-class structures, captive fund-of-fund structures, indeed, investment funds are themselves commingling instruments whose main purpose is, among others, the management of the assets as one combined pool.

The common element in all these structures, past and future, is combined asset management.

The ability to commingle for the purpose of combined asset-management on a cross-border basis, involving funds in domiciles managed by the same investment manager (or by investment manager entities of the same group), is key to achieving the full benefits of commingling.

Fragmentation – a fact of life

The European investment fund market is fragmented along multiple lines, from end-consumer segments to distribution channels, and institutional arrangements. Not all of these run along national lines.

Fragmentation generally means higher costs in forms of lower average lot sizes in terms of products and related production and distribution activity.

There are important barriers to consolidation in a single-market context. The classic route of mergers is fraught with difficulties and legal obstacles in the investment fund world. This prevents product consolidation. More importantly, it will prevent company consolidation: the inability to merge products cross-border will reduce the attractiveness of an asset-management company with fund products to a potential buyer with its own existing products.

At the same time, it must also be recognised that a single-market context does not equate to a single product platform. A company with a strong presence in multiple on-shore European fund markets might very easily choose to have separate product lines in some of these markets. It will not always be the choice of the market to consolidate product in any given situation – on-shore/offshore product splits will in many cases remain.

Benefits of commingling : mitigating the costs of UCITS fragmentation

- **better execution**
- **lower front-office costs**
- **lower back-office costs**

Asset management firms worldwide are struggling to achieve more efficient cost structures around their businesses. This is resulting from competitive pressures in the asset management industry. As asset management is a globalised industry, it is a global phenomenon. This includes achieving a lower unit cost of production internally, outsourcing areas of activity which are better done at scale by specialists.

European asset management firms must find ways of adapting their cost structures to these competitive pressures, or lose out.

Pooling provides opportunities for asset managers to offset the inherently higher costs that result from a more fragmented investment-fund industry in Europe than in other fund markets.

The reality of the fragmented European investment-fund market cannot be changed in the medium term. It is not certain that changing this would be desirable : Europe's diversity is not on the table. Rather, the object is to find ways and techniques to maintain a competitive cost structure in spite of this fragmentation.

Pooling is designed to achieve precisely this.

Pooling allows a lower cost of production costs while maintaining a higher degree of product diversity to cater to a more fragmented state. In short, it allows the cost of fragmentation to be overcome, and thus helps keep European fund products, and European asset managers, competitive and at lowest possible cost.

The benefits can be broken down into three categories.

Trade Execution : the hidden cost of fragmentation - higher spreads

Sell-side brokers providing quotes to the market will adjust these quotes to reflect the cost of the underlying tickets that any given trade will generate. It is common practice for investment managers to buy block securities and allocate these to different managed portfolios (known as "block-trading"). For each underlying managed portfolio receiving a part of a given trade, the broker will be required to produce a separate ticket for each underlying managed account for settlement purposes, and separate securities and cash settlements will occur for each.

In liquid bond and equity markets, brokers will quote spreads which reflect the number of separate tickets, and settlements, the trade will generate, reflecting the broker's increased costs.

This has a direct impact on execution, and in turn on performance, of the managed accounts. Moreover, this execution directly affects the end-investor: the market price is the price booked by the asset manager to the end-investor.

For example in government bond markets, competitive spreads are ca. two basis points. This spread can easily increase to three or four basis points where a trade is associated with multiple tickets. For the daily billions passing through the government bond market, this is material to end-investors in European fund products.

Similarly in blue-chip equity markets, competitive spreads are ca. fifteen basis points. This spread can easily increase by three to five basis points where a trade is associated with multiple tickets.

Commingling products with similar asset classes would immediately remove this fragmentation cost. It is very likely that the operational or others costs generated by commingling structures would be far less than the 20 – 50% spread reduction on liquid asset classes.

Front-office : cost and capacity of asset management specialists

The main cost constraint component in the front-office cost structure of an asset manager is the cost of investment management specialists (traders). There is a fixed people overhead to managing an account (being it a fund or a portfolio account) with specific investment objectives – it is thus difficult to scale this cost component and achieve lower unit costs. It will take double as many specialists to manage six accounts as it would to manage three accounts.

Compounding this mechanical and basically linear cost problem is the capacity constraints of specialised investment managers, and their relative scarceness in the labour market. Traders are highly specialised, expensive employees. This exacerbates a linear problem and renders it an exponential one: capacity constraints cannot simply be overcome by spending more, they inhibit growth as business is delayed or shelved.

Investment managers indicate that this front-office cost component alone could reach as much as ten basis points.

These cost savings would accrue to the asset management companies increase their competitiveness. They would increase the competitiveness of the products of asset managers, particularly in relation to products from large, homogenous and scaled markets outside Europe.

Ultimately, it must be assumed that they would feed back through to the end-investor through the competitive market mechanisms.

Middle and back-office : a question of scale

Middle and back-office costs have not been at forefront of concerns over the costs of fragmentation – it is believed that execution and front-office costs are of a greater order. However, it is generally agreed that the fragmentation of the fund industry does lead to higher middle- and back-office costs. Smaller transaction volumes at higher average transaction sizes, fewer trading accounts, lower and degressive service-provider fee schedules are obvious examples of scale opportunities of commingling.

These cost savings would accrue partially to the end-investors directly in terms of lower transaction costs and degressive fee schedules by service providers.

They would also partially accrue to the asset management companies and to a lesser extent to service-providers. They would increase the competitiveness of the products of asset managers, particularly in relation to products from large, homogenous and scaled markets outside Europe. Ultimately, it must be assumed that cost savings accruing to asset managers and service providers would feed back through to the end-investor through the competitive mechanisms in the market for asset management.

Costs of Commingling

Service-Provider Fees – Virtual Pooling

Pooling technology is well-established in cross-border UCITS domiciles. Existing pooling structures in these same domiciles are generally large structures with large quantities of funds and assets. Thus, there is considerable experience and familiarity with pooling structures.

In the UCITS space, virtual pooling is primary existing method – entity pooling is not possible due to UCITS diversification requirements. Virtual pooling technology can be complex and sophisticated depending on the level of sophistication of the product and the service-provider. An indicative level of pricing premium for pooling could be summarised as follows :

Funds participating in
Virtual Pooling structures : 0 to 1bp premium

Cost of “virtual pools”
(borne by participating funds
pro-rata to their ownership) : €15 000 per annum

In a pool of, say, €50m the resulting basis point cost to the participating funds would be 3bps. In the more likely case of a pool with €150m in assets, it would be 1bp. A pool of €300m would bear a cost of 0,5bp or less.

Using these rudimentary but reasonable assumptions, 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.

Much or all of this “premium” can be absorbed by savings in other back-office costs – transaction and settlement costs, safekeeping costs, due to pooling accounts with larger holdings and larger trade tickets.

Savings in front office costs and execution, accruing to the Fund and to the Investment Manager, far outweigh the additional service-provider costs in virtual pooling.

Service-Provider Fees – Entity Pooling

The cost of servicing an additional fund – the entity pool – is the additional cost associated with entity pooling.

Incremental costs involve primarily accounting of pass-through funds (funds investing into the commingling fund. Holdings would be units of the commingling fund; this represents “light accounting”. Moreover, a degressive schedule would apply to the commingling fund, taking into account all the pooled assets. The “heavy-duty” accounting would remain but would shift from multiple participating funds to one or more (but fewer) commingling funds. Viewed on a net basis, the accounting premium could reasonably be estimated to lie in the range of 1 to 3 basis points. In larger structures, it could be under 1bp.

This would be offset by lower safekeeping and transaction costs, due to pooling accounts with larger holdings and larger trade tickets.

Depository costs would be increased marginally for the pass-through funds – holdings of cash and units of the commingling fund. This would be more than offset by reduced costs of the depository for the commingling fund for the larger pool of assets - larger trade tickets and larger assets in one account would result in lower transaction and safekeeping costs.

Savings in front office costs and execution, accruing to the Fund and to the Investment Manager, far outweigh the additional service-provider costs in virtual pooling.

Other costs

There are no additional charges or costs of pooling elsewhere in the value-chain. It is possible that the Investment Manager has to set up a somewhat more robust compliance monitoring infrastructure in order to monitor compliance at both levels: pool and participating funds.

However, these will be primarily one-time set-up costs and will be far outweighed by the cost reductions to the Investment Manager through the ability to focus primary asset management on pools rather than individual funds.

Similarly, in entity pooling the governance of an pool entity will result in additional cost, which will be incremental to the governance cost of the entire structure. Here again, it is estimated that these incremental costs can generally be far outweighed by cost savings to the participating funds along the entire value chain.

C. Barrier Inventory and Solution Elements

	Investment funds (UCITS)	Pension funds
Entity pooling	<p>Withholding tax The pool must be considered fiscally transparent for withholding tax purposes.</p> <p>Investment regulations The UCITS Directive diversification requirements must be amended to permit entity pooling.</p>	<p>Withholding tax The pool must be considered fiscally transparent for withholding tax purposes.</p> <p>Accounting and performance CEIOPS must advise on accounting and performance.</p> <p>Investment regulations Mechanism for pension funds to apply CEIOPS diversification rules.</p>
Virtual pooling	<p>Custodial regulations Depository to delegate custodial functions on cross-border basis.</p> <p>Clarification Clarification and interpretation is required for issues related to quality of ownership, accounting policies, independence, operational risk, and other.</p>	

D. Proposed Measures

Recommendations

1. The UCITS Directive should be amended to allow designated Commingling Structures as harmonised European funds.
2. Designated Commingling Structures under an amended UCITS directive should be subject to the following conditions :
 - The UCITS fund wishing to commingle its assets into another UCITS must be designated as a Designated UCITS Commingling-Out Fund (DUCOF) investing into at least one designated UCITS (DUCIF)
 - Both DUCOF and DUCIF must be a UCITS fund
 - DUCOF may invest up to 100% of its gross assets into the DUCIF with no minimum investment
 - the named Investment Manager of the DUCOF must be the same entity as the named investment Manager of the DUCIF, or, the named Investment Managers of the DUCIF and DUCOF must belong 100% to the same asset management group or under "common control" of a single group *
 - The investment limits under Article 24 of UCITS III with respect to diversification should be amended to apply only to the assets of the DUCOF which are not invested in a designated DUCIF
 - All other requirements of Article 24 of UCITS III continue to apply
 - DUCIFs may not invest in DUCOFs within the same structure
3. Appropriate disclosure requirements should apply to Designated Commingling structures including in particular fee arrangements between the DUCIF and DUCOF.

4. Appropriate mechanisms should be in place to ensure no “double-charging” of fees to DUCOFs, following the example of existing UCITS III provisions allowing UCITS funds to invest in other UCITS funds.
5. The UCITS III Directive should be clarified or amended to allow the appointment by the Depository of a global sub-custodian based in the EU under its responsibility.
6. The European Commission should propose CESR as a venue for national regulators to discuss pooling in its different forms, for the purpose of educating regulators, define legitimate issues and concerns, and develop guidelines for UCITS pooling structures.
7. The European Commission should give CESR a comprehensive mandate, equivalent to a Level III review in the Lamfalussy process, to examine and, where appropriate, to clarify and/or to develop guidelines for the following questions in relation to virtual pooling :
 - confirm that virtual pooling falls within possibilities of current UCITS III directive
 - confirm independence of investment and accounting policies of investment funds participating in a pooling structure
 - confirm that duties of the named Investment Managers and named Depositories of investment funds participating in a pooling structure remain unchanged
 - clarify accounting and valuation principles in pooling mechanism
 - confirm that the quality of ownership of assets remains unchanged and, if appropriate, develop conditions to ensure that such is the case
 - clarify potential dilution effects on investment funds participating in a pooling structure
 - confirm requirements for counterparty identification for joint trading accounts
 - clarify disclosure requirements
 - identify concerns around operational risk and measures to mitigate such risk

** There is precedent for defining a group of funds managed by one entity, or distinct entities under the control of one group, in UCITS under Article 24 of the 1985 Directive.*

E. Possible supervisory/investors protection objections and other drawbacks of the different types of pooling

UCITS Designated Commingling structures

1. The absence of diversification of the DUCOF if invested above current limits in UCITS III with respect to UCITS holding other UCITS
 - The required diversification is achieved through the requirement that the DUCIF be a UCITS III fund, and that it would not be allowed to invest into a DUCOF.
 - The absence of economic diversification has never been identified as an issue in previous European-level discussions around Designated Commingling.

- Several domestic markets authorise Designated Commingling structures for non-UCITS funds.
 - An alternative approach would be to treat diversification on the basis of a look-through from the DUCOF to the holdings in the DUCIF. This alternative has been discarded due to the fact that currently holdings of funds by UCITS III funds do not apply the look-through principle to determine limits or actual exposure.
2. A two-tiered fund structure makes investors subject to a lack of transparent cost structures.
- Currently UCITS III allows two-tier structures to the extent that UCITS III funds may hold up to specific limits in other UCITS funds. Thus there is a precedent. In addition, a number of national markets allow Designated Commingling structures. Proper disclosure is of course key.
3. Lack of clear regulatory oversight if DUCIF and DUCOF are in two different jurisdictions.
- Currently UCITS III allows two-tier structures to the extent that UCITS III funds may hold up to specific limits in other UCITS funds. There has never been a concern raised in this context about competing regulatory jurisdiction.
 - Both DUCIF and DUCOF will be subject to clear regulations and governance under the UCITS Directive and within the regulatory structure of their respective domiciles.
 - Similarly, the roles of the respective named Investment Managers and Depositories of the DUCIF and DUCOF are clear, are in no way diluted or changed, and apply fully to the fund for which they are respectively named.
4. The existence of cross-border Designated Commingling structures leads to a more fragmented European market.
- We believe that the costs of any resulting fragmentation can be reduced or eliminated, in addition to other benefits, through cross-border Designated Commingling structures that the market establishes.
 - The market will use cross-border Designated Commingling structures to maximise the efficiency of the industry. If additional fragmentation were to be the result of this, it would be because the market was seeking to obtain greater efficiency.

F. Pre-requirements, mitigating measures, savings sharing

The nature of the Designated Commingling structure is quite precise and specific. A targeted, surgical amendment to the Directive specifically to enable UCITS Designated Commingling structures is the best way of ensuring that the desired result in terms of optimised legislation, and the resulting effect in terms of efficiency and cost-savings, is achieved.

Concerning Virtual Pooling, there are no specific regulatory reasons which would prevent its usage on a cross-border basis. A concerted effort by CESR to provide clarification and education would make the technique and its benefits more transparent. This would considerably simplify the task of product promoters seeking regulatory approval of cross-border virtual pooling structures.

Savings (generated by all types of pooling) will accrue directly to fund products, and hence directly to end-investors with no reliance on intermediaries to pass through the savings and no

reliance on the market mechanism, in two manners: better trade execution and lower transaction and custody fees.

Savings will accrue to asset managers (often as fund promoters) through lower cost structures – some of these savings will feed through the value-chain to end-investors through the market mechanism.

Both these savings sources will have a positive impact on the competitiveness of European fund products and asset managers.

G. Feasibility and costs identification

- There are no costs of implementation other than to amend the UCITS Directive, and transpose the amendment into national legislation.
- There could be some interpretation work required – much depends on the wording of the related amendment to the Directive.
- Designated Commingling fund structures as proposed could be implemented by practitioners relatively easily, using most of the existing UCITS III Directive, transposing legislation and the body of both national and co-ordinated interpretations already in place.

H. Other possible solutions

Cross-Border Master-Feeder Structures

- Master-Feeder structures under a strict definition – feeders invest only in master without holding own securities – are perfectly feasible on a cross-border basis under the DUCIF and DUCOF framework recommended in this report.
-
- Restricting the ability to commingle to this definition of Master-Feeder would unnecessarily restrict the potential of commingling, while offering no discernable benefit.

Facilitation of Fund Mergers

- An easy and functioning mechanism for achieving fund mergers in Europe would, in some cases, provide an alternative to cross-border pooling structures including Designated Commingling structures.
- However, Designated Commingling structures can provide the benefits of commingling for fund products which are going concerns with well established franchises and with no desire to merge.
- It is incorrect to view pooling, including Designated Commingling structures, as a second-best replacement for an easy way to achieve fund mergers. Even in the spirit of the single market, there are legitimate reasons to have different products for different segments, such as on-shore and off-shore products sold to different countries or groups of countries.

Fund-of-Fund Liberalisation

- The same and possibly greater impact on the fund industry could be obtained by allowing unrestricted Fund of Funds structures.
- Fund of Funds liberalisation accomplishes a much different objective, far beyond achieve cost savings through commingling: it allows full product-outsourcing by one product to another – of investment management expertise and product infrastructure (manufacturing functions), retaining the selling role (distribution function).
- Fund of Funds liberalisation would potentially change much more in the UCITS industry than allowing lower costs through commingling. These potential effects have not been the subject of industry study or debate. Furthermore, it should be noted that the various calls by industry forums (Expert Group on Asset Management – May 2004; EC Green Paper on UCITS – July 2005 and others) have called for the use of pooling structures to be facilitated – no such calls have been made regarding fund-of-fund structures.

Pooling for Pension Funds

A. Scene Setting

What is pension pooling?

Pension pooling, as defined by this report, refers to the pooling of pension scheme assets through a collective investment scheme – for example, a Dutch and a Belgian pension scheme pooling their assets through an Irish common contractual fund, or a French FCP.

There are other ways of pooling pension assets – for example, by using information technology to achieve a virtual pooling of assets without having to rely on a collective investment scheme.

B. Rationale

Fragmentation – a fact of life for European pension funds

Pension funds are interwoven tightly into the economic, social and fiscal fabric of individual countries. As such it remains impossible to establish, in Europe, a European pension fund entity containing the assets of pension funds of a large group with operations in multiple European countries. While the Pensions Directive does much to remove barriers and impediments to this, important barriers remain, particular in the area of taxation. It is unlikely that these will be removed any time soon. It is also uncertain whether the ECJ, should it be seized on the issue of barriers to pension funds, would permit the wholesale dismantling of national pension structures against the wishes of a European member state.

Thus, the existence of national pension structures, and in turn national pension plans, will be with us for the foreseeable future. The resulting fragmentation of European pension funds will cause, and is causing, many in the industry to look at commingling alternatives for the purpose of combined asset management of European pension funds.

Benefits of pooling for pension funds – mitigating the cost of fragmentation of European pension funds

Reference is made to Page 27 “Benefits of commingling : mitigating the costs of UCITS fragmentation”. This section describes benefits in terms of :

- **better execution**
- **lower front-office costs**
- **lower back-office costs**

which are the same as the benefits for commingling pension funds. (For brevity, they will not be repeated in this section.) These accrue to plan sponsors and plan beneficiaries, much in the same way of benefits accruing to end-investors and asset managers of UCITS.

In addition, pension funds have additional specific benefits that are sought by group pension sponsors

- better and more standardised control over investment objectives

- more consistent investment performance across group pension entities for a similar asset class
- access to specialised investment management expertise for small pension entities in a group
- under cross-border pooling arrangements, pension liabilities remain in country of individual pension plans

These benefits accrue to different parties – plan sponsors, plan beneficiaries, national governments.

The primary benefit for scheme sponsors is better control over the investment process, since it enables them to appoint a common investment manager(s) to the pooled assets of schemes which they sponsor for employees of their subsidiary companies in different countries. Also, pooling enables the sponsor to appoint best-in-class investment managers to schemes which otherwise would not have the scale to make such appointments directly. For example, a multi-national sponsor of large pension schemes in Finland and Norway and small schemes in Denmark and Sweden could appoint a best-in-class European equities manager to investment the assets of the pooled schemes, ensuring consistent control over the investment process, and enabling the smaller Danish and Swedish schemes to enjoy the expertise of a manager that they would have been too small to appoint directly.

The primary benefit for governments is that pooling enables scheme members to enjoy economies of scale, and scheme sponsors to enjoy control over the investment process, without pooling the *liabilities* of schemes in different countries. For example, consider a multi-national sponsor of a scheme that is in deficit in the UK and a scheme that is in surplus in Ireland. Pooling enables those schemes to enjoy the benefits of assets pooling, without pooling the scheme liabilities. If they were able to pool liabilities, this would benefit the UK scheme at the expense of the Irish scheme, which is something the Irish government would object to (having provided tax relief to Irish scheme members, and being responsible for safeguarding their interests). In other words, pension pooling is the closest we are likely to get to a pan-European pension all the while tax remains the prerogative of Member States, and is therefore closest approximation to a single market for pensions that we can achieve at the present time.

Costs of Commingling

Reference is made to Page 29 “Costs commingling”. This section describes the costs of commingling for UCITS funds, either in entity or virtual pooling structures. The costs would be comparable in entity or virtual pooling structures for pension funds. (For brevity, they will not be repeated in this section.)

C. Barriers to pension pooling and solution elements

There are no substantial regulatory barriers to pooling for pension funds.

	Investment funds (UCITS)	Pension funds
Entity pooling	<p>Withholding tax The pool must be considered fiscally transparent for withholding tax purposes.</p> <p>Investment regulations The UCITS Directive diversification requirements must be amended to permit entity pooling.</p>	<p>Withholding tax The pool must be considered fiscally transparent for withholding tax purposes.</p> <p>Accounting and performance CEIOPS must advise on accounting and performance.</p> <p>Investment regulations Mechanism for pension funds to apply CEIOPS diversification rules.</p>
Virtual pooling	<p>Custodial regulations Depository to delegate custodial functions on cross-border basis.</p> <p>Clarification Clarification and interpretation is required for issues related to quality of ownership, accounting policies, independence, operational risk, and other.</p>	

Specifically, the Occupational Pensions Directive appears permits a pension scheme to invest as much as 100% of its assets in a single collective investment scheme, since, at a meeting of the European Commission and Member States on 22 October 2004 it was stated that:

“Indirect investments via collective investment vehicles, where underlying assets are traded in regulated markets, should be treated as being equivalent to direct investment on regulated markets, based on a ‘look through’ principle.”

It would be useful if the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) reviewed Member States’ transposition of the Occupational Pensions Directive to confirm that pooling is, indeed, permissible, but, other things being equal, it would appear to be so.

Tax barriers, on the other hand, remain formidable, in particular withholding tax.

Payments of interest and dividends are typically made net of withholding tax. The rate of withholding tax depends on the double tax agreement (DTA) of the country of residence of the company making the payment and the country of residence of the investor receiving the payment. Typically, the rate of withholding tax prescribed by a DTA will depend on the nature of the payment (e.g. dividends, interest, royalties, rent etc) and the nature of the investor (typically requiring that the investor be a resident person beneficially entitled to the payment).

For example, under the US-UK DTA, UK pension funds are entitled to receive gross dividends from US companies, whereas under the German-US DTA, German pension funds are entitled to

receive US dividends net of 15% withholding tax. If a UK and German pension scheme pooled their investments in US equities, they would require to receive US dividends gross and net of 15% withholding tax respectively. The pooling solution should be 'tax neutral'.

In order to achieve tax neutrality, the collective investment scheme used to pool scheme assets should be considered 'fiscally transparent'. A transparent entity is one that is disregarded for DTA purposes – that is to say, the DTA between the company making the dividend payment and the pension scheme receiving the payment is applied, irrespective of the fact that the assets of the pension fund have been pooled in a collective investment scheme. (See diagram.)

Opaque and transparent entity pooling

(It should be pointed out that a fiscally transparent collective investment scheme would not only assist the single market for pensions, but is also required if pan-European private equity funds are to become a reality, as described in the other expert group report on alternative investments).

Every country uses different criteria to determine whether or not an entity is transparent. Those criteria typically relate to legal concepts of ownership, which differ from country to country. Consequently, the challenge for pension pooling has been to identify an entity that is considered transparent in all Member States of the EU, and all target countries of investment (which could potentially include the whole world, but at a minimum should include members of the OECD).

This has proven to be a tall order despite the best efforts of governments and the asset management industry.

Previous analyses have identified three possible solutions: a European Directive that requires Member States to mutually recognise certain entities as fiscally transparent; a specially constituted task force of Member State fiscal authorities to consider the issues, following the precedent of the Joint Transfer Pricing Forum; and a common approach to fiscal transparency, developed through the auspices of the OECD.

We strongly support the last solution – that that the Commission should co-ordinate Member State representation on the OECD Working Party No 1 on Tax Conventions and Related Questions, which is currently considering the application of the DTAs to collective investment schemes, and should be encouraged to identify the circumstances in which such entities should be considered fiscally transparent in order to facilitate pension pooling. The advantages of this approach are that an OECD-level solution is more apposite than a European Directive (since the OECD has a specific mandate to facilitate co-operation in the area of international taxation), would have a wider scope (since an EU Directive would only bind Member States of the EU, whereas an OECD-level solution would have a more international impact), and is timely (since the OECD is currently considering precisely this issue).

D. Recommendations

1. CEIOPS should review Member States' transposition of the Occupational Pensions Directive to confirm that pooling is, indeed, permissible, but, other things being equal, it would appear to be so.
2. The European Commission should co-ordinate Member States' representation on OECD Working Party No 1 on Tax Conventions and Related Questions, and propose a basis for international mutual recognition of fiscally transparent entities.

E. Savings Sharing

Savings (generated by all types of pooling) will accrue directly to pension schemes, and hence directly to end-investors with no reliance on intermediaries to pass through the savings and no reliance on the market mechanism, in two manners: better trade execution and lower transaction and custody fees.

Savings will accrue to asset managers through lower cost structures – some of these savings will feed through the value-chain to scheme beneficiaries through the market mechanism.

Both these savings sources will have a positive impact on the performance of European pension plans.

The Management Company

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Annex to the report of the EU Market Efficiency Working Group Report of the Sub-group on the management company passport

Directive 2001/107/EC¹⁸, (the 'Management Company' Directive 'MCD' or 'the Directive') was intended to breathe life into the UCITS management company, which, until that point, was a purely domestic vehicle that existed to manage FCP's, Unit Trusts and those corporate funds which chose not to manage themselves.

The Directive was a departure from the European legislator's hitherto exclusive focus on the UCITS product and aimed to grant to management companies the right to passport their 'collective portfolio management' ('CPM') services in a manner similar to other financial intermediaries under the principle of mutual recognition.

In addition, the Directive grants to the UCITS management company the ability by way of derogation to become authorised to provide, and to passport, some 'bolt-on' services listed in MiFID under operating conditions laid down in that Directive.

In short, the Directive appears to have intended to re-launch the UCITS Management Company as a pan-European intermediary capable of providing its 'traditional' services cross-border along with some other services the provision of which to that point in time had been the exclusive preserve of MiFID firms and Credit Institutions.

To date, the objectives of the Directive have not been met.

At present, it is not possible for a UCITS to designate a management company in another member state. The fundamental freedom offered by the Directive is therefore still not available for corporate type funds still less for 'common' or contractual funds which the Directive's text does not attempt to cater for.

The demands for increased substance in UCITS Management Companies combined with the continued failure to offer the fundamental single market freedom to passport has resulted in decreasing cost and control synergies.

This Annex aims to (1) analyse the position prior to the adoption of the Directive, and describe what the Directive says about the new freedoms accorded to management companies and how and to what extent these freedoms are currently available. Having assessed what is and is not available, we move to a review (2) of major market participants attitudes to these freedoms, their availability/desirability and the efficacy of existing alternatives to these freedoms. This section of the report is based on interviews with EU Market Efficiency Working Group members representing 15 pan-European promoters from 12 Member States with UCITS assets under management in excess of Euro 3 Trillion (over 60% of the AUM of all European UCITS). We then go on (3) to comment on and respond to the major barriers identified by respondents to the Commission's green paper on investment funds.

¹⁸ All references in this Section of the report to Council Directives 85/611/EEC and 2001/107/EC are references to the consolidated version of the Directives published on at http://europa.eu.int/eur-lex/en/consleg/pdf/1985/en_1985L0611_do_001.pdf

1(a) The situation prior to passing of the Management Company Directive.

(i) Managing UCITS and non-UCITS domestically

Article 5(2) of the Management Company Directive introduces into EU law for the first time the explicit ability for a management company operating in accordance with the Directive (i.e. a UCITS III management company acting as such) to manage non-UCITS funds. The 1985 Directive 85/611/EEC (Article 6) did not provide for this. Despite this, our understanding is that in the main European fund domiciles, this ability existed under the 1985 Directive albeit on a domestic, non-passportable basis only.

(ii) Providing other Services domestically and cross-border

Our research indicates that, even prior to the passing of the Management Company Directive, some promoters were in a position to avoid the restriction imposed by Article 6 of Directive 85/611 EEC which prevented management companies from carrying on activities other than the management of unit trusts, contractual funds and investment companies. The 1985 Directive recognised this by providing for a grandfathering period of 5 years for such companies after which they were required to cease providing such services. Our understanding is that, despite this, today, at least some UCITS I (i.e. not yet converted) management companies were authorised separately under the ISD to provide on a cross border basis some investment business services and also services not otherwise regulated. We have been unable to ascertain whether any UCITS III management companies provide/ continue to provide services not contemplated by Articles 5 and 6 of the Management Company Directive.

(1)(b) What Freedoms does the MCD say it is introducing and what is available today?

The MCD introduces in Article 5 licensing, capital and internal control standards for UCITS management companies to be met at the latest by 13 February 2007.

In return for compliance with these obligations, management companies which convert to, already comply with or are created as 'UCITS III compliant' management companies become eligible for the rights of establishment and freedom to provide services described in Article 6.

Article 6 (1) provides that 'Member States shall ensure that a management company authorised 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 authorised*, either by the establishment of branches or under the freedom to provide services. Article 6(2): 'Member States may not make the establishment of a branch or the provision of the services subject to any authorisation requirement, to any provision to provide endowment capital or to any other measure having equivalent effect.' Article 5(1) provides that access to the 'business of management companies' is subject to prior official authorisation in the home state. Authorisation granted under the Directive to a management company '*shall be valid for all member states*'.

Article 5(2) provides that UCITS III management companies can't engage in any other activity except the management of non-UCITS UCI's and notes that Annex II lists, 'in a non-exhaustive manner', the functions *included* in the 'activity of management of unit trusts/common funds and investment companies' which presumably is the key component of the 'activity for which it has been authorised'.

Article 5(3) grants a derogation from this restriction and grants management companies the right to manage portfolios of investments on a discretionary basis. Assuming they provide this service they are also entitled to provide the services of 'investment advice' and safekeeping of units of collective investment undertakings.

The reality of the situation today

1(c)(i) Domestic Management of UCITS and non-UCITS UCI's

In most Member States, the ability of a UCITS I or UCITS III management company to manage UCITS I or UCITS III funds or a combination of both is clear. It is to be expected that after the elapse of the grandfathering period on 13 February 2007 any residual problems in this respect will have disappeared as on that date all UCITS management companies must be UCITS III compliant and all UCITS must be equally so. As noted above, it is our understanding that at least in the main European fund domiciles, the ability of UCITS III management companies to manage non-UCITS UCI's domiciled in their own jurisdiction is unquestioned.

1(c) (ii) The activity of 'Collective Portfolio Management' – can it be provided cross-border?

The Preamble to the Management Company Directive introduces the concept of single market freedoms for the UCITS management company foreseeing the establishment of branches and provision of services on a freedom to provide services basis by such companies in member states other than their home member states.

The preamble notes that the approach adopted to permitting such single market freedoms is to harmonise to the extent necessary the domestic regulation of the management company in a manner sufficient to secure the mutual recognition of authorisation making the grant of a single authorisation valid throughout the EU through the application of home state supervision. So, in order to be permitted to passport their activities a management company must be regulated and organised to a minimum standard prescribed by the Directive.

Recital 6 appears to confirm that management companies which have met the minimum harmonised standard of regulation are, under the principle of mutual recognition, permitted to perform in host member states the activities for which they are authorised in their home member state. Recital 7 elaborates on this theme.

We are not aware of any example of a management company domiciled in one member state managing a fund domiciled in another on behalf of an investment company, or the management company of a common fund. We are, however, aware of two examples, the UK and Italy, where, in the transposition of the Directive, provision was made for the management of a local corporate fund by a foreign manager. In Luxembourg, the original CSSF circulars introducing detailed rules for the authorisation and running of UCITS management companies also contemplated the management of Luxembourgish SICAV's by EU management companies. However, the CSSF has since adopted the position that, failing the mutual recognition of this principle by all member states, this freedom should not be accorded to foreign management companies wishing to manage Luxembourg domiciled funds.

The potential benefits of the management company passport are completely eroded without the ability for all UCITS types to designate a management company in another jurisdiction.

2(c)(iii) Is CPM one passportable activity or four or more?

The recitals to the Directive suggest that the activity of ‘collective portfolio management’ is divisible and potentially passportable on a piecemeal basis by referring to the passportability of the ‘functions included in the activity of CPM’. In the two major ‘exporting’ member states, Ireland and Luxembourg, such piecemeal passportability would not appear to be provided for by the Regulator. However, Annex II reinforces this suggestion by dividing the ‘functions included in the activity of collective portfolio management’ into three categories, ‘Investment Management’, ‘Administration’, and ‘Marketing’. Are these activities capable of being provided cross-border? Is a passport required? Can they be provided cross-border despite the inability to passport CPM?

‘Investment Management’

With regard to ‘investment management’ (i.e. portfolio management services to collective investment vehicles), CESR’s view in their ‘Guidelines to Supervisors regarding transitional provisions of the amending UCITS Directives CESR/04-434b’ is that where a fund appoints an entity authorised as a UCITS management company in another member state to provide investment management services, that entity does not need to be passported into the domicile of the fund. CESR state that this is on the basis that these services are not being carried out in the member state of the fund. (One would have thought however, regardless of the correct answer to where the service is being performed, that CESR would have regarded notification under freedom to provide services principle to have been appropriate.)

CESR state however, that the entity providing investment management services needs to be subject to prudential supervision and therefore must be *authorised* under the ISD or the UCITS Directive. This is confusing since UCITS management companies can only be authorised as such. When availing of the derogation provided for in Article 5(3) they continue to be authorised under the UCITS Directive but subject in the provision of those services to the operating conditions set out in various specified articles of 93/22/EEC (ISD) and 2004/39/EC (MIFID).

Nonetheless, it would appear to be the case therefore that ‘investment management’ is an activity that can be provided cross-border by management companies without the need for any form of passport and independently of the provision of CPM services to the client fund. CESR’s comments in this respect are confined to the provision of investment management services to UCITS. One would assume that the interpretation extends to the provision of such services to non-UCITS. When it comes to the provision of investment management services on a client-by-client basis one assumes that a Management Company must have availed of the derogation provided for in Article 5(3) although CESR do not address this question.

‘Administration’

The ‘Administration’ function contains a number of activities which may today be performed in-house by the management company or appropriately licensed group member, or they may be outsourced to the depositary bank, the trustee, the fund administrator, the registrar/transfer agent of the fund or to another third party entity which, depending on the local regulatory environment, may or may not be licensed for the provision of the service.

Unlike the ‘investment management’ function, the passportability or ability otherwise to provide cross-border of which has been clarified by CESR, it is unclear whether the activities under this heading are capable of being passported intra-EU independently of the other activities i.e. can a

management company managing a UCITS in one member state provide regulatory compliance services or unit issuing services to a fund domiciled in another state regardless of whether that management company can or is providing CPM services to that fund?

This would conceivably be a very useful facility. One could imagine that promoters may be anxious to house regulatory compliance monitoring for all group UCITS from one location. The fact that the descriptions of the component activities are rather vague and that some of them look similar to the 'investment business services' regulated in ISD/MiFID and indeed available as non-core services (safekeeping and administration in relation to units of CIU's) is unhelpful and confusing.

In addition, as noted in Recommendation 3 in the Summary, a number of the functions listed under the heading 'Administration' are those that the major exporting Member States regard as being essential to perform in the home state of the fund in order to comply with the 'head office' principle thereby requiring a management company performing them or delegating their performance to perform them itself or delegate them back into the home state of the fund. There was no unanimity in the group on what should be done about this conflict. This is something that we would ask the Commission services to investigate further.

'Marketing'

Annex II to the Directive simply lists 'Marketing' as a function included in CPM. Recital 7 to the Directive specifically mentions the ability of a 'harmonised' management company to distribute the units / shares of the funds which it manages. CESR's view, in CESR/04-434b, is that the distribution of the units/shares of a UCITS managed by itself through a branch is subject to a passport requirement although we are not aware of any member state catering for this possibility in their national law. In addition, CESR's view is that the distribution of third party funds should be included in the scope of permissible activity of a management company.

This interpretation suggests that it is an activity that is independently passportable from CPM. In a regulatory environment where neither the UCITS Directive nor ISD/MiFID otherwise provides a specific basis of authorisation for the activity of distribution of units/shares of collective investment vehicles this interpretation is particularly useful. However, again, to the extent that we are aware, in the main exporting countries the Regulator has not adopted this interpretation i.e. that 'marketing' or distribution of fund units is an independently passportable activity regardless of whether or not CPM services are also being passported.

It is worthwhile noting at this point that whilst CESR's wide interpretation of the term 'marketing' is a useful and, in our view, sensible one, the term 'marketing' as understood in the European funds market may either encompass or be completely separate from the activity of 'distribution'. It is relatively common for the activity of 'marketing' of funds to be performed by a group entity different from that which is responsible for entering into distribution agreements. It is also worth noting that typically the entity responsible for marketing or distribution or both will not be the management company but a company dedicated to this activity.

2(c)(iv) The 'bolt-on ISD services

Article 5(3) of the Directive contemplates by way of derogation from Article 5(2) management companies operating in accordance with the Directive having the ability to engage in management of portfolios of investments, including those owned by pension funds on a discretionary client by client basis. Based on the very limited data available, our research

indicates that less than 1% of management companies which have converted to UCITS III, or have been created as UCITS III compliant companies have sought to avail of this freedom.

Our information is that, generally, this freedom together with the associated 'non-core' activities of 'investment advice' and 'safekeeping and administration in relation to units of collective investment undertakings' are generally available in Member States which have transposed the Directive to UCITS management companies on a passported or freedom to provide services basis in accordance with Article 6, 6(a) and 6(b) of the Directive.

MiFID has made the service of 'Investment advice' a 'core' (independently passportable) activity for MiFID firms. We see no reason for this not to be extended to UCITS management companies which would mean that UCITS managers could, by derogation, become authorised to provide investment advice without also being authorised to carry on 'management of portfolios of investments...' This latter heading of authorisation has been amended under MiFID to 'Portfolio Management'. We recommend that this be reflected in any amendment of the UCITS Directive also.

The second existing non-core heading of activity available to UCITS managers, 'safekeeping and administration' is limited under the Directive to units of UCIs (presumably including non-UCITS). We would question the rationale for this limitation given that the ability to provide investment advice is available to UCITS managers in respect of all instrument types under Section B of the Annex to the ISD, (which should now be section C 'financial instruments' under MiFID.)

In general, we do not believe that there is a real demand or rationale for full interchangeability of the services provided by UCITS managers and MiFID firms – i.e. we do not see a need for UCITS managers to be able to provide the range of services that a MiFID firm can. Again, this is because promoters generally have companies dedicated to specific regulated activities, and whilst there does appear to be a demand for these specialised companies to be able to provide their services cross-border there appears to be limited appetite to combine the all activities in one legal entity. However, we do believe that there is merit in investigating the desirability of 'CPM' being included as an activity for which MiFID firms are entitled to seek authorisation under the operating conditions of the UCITS Directive.

We question the continuing validity of the rationale for the selection of the 'bolt-on' ISD services made available through the Directive.

We would suggest reviewing the extent to which other MiFID services should be made available to UCITS Managers – particularly for instance the 'receipt and transmission' and 'execution of orders' activities. It is conceivable that a UCITS management company which is utilised by a promoter as the passported sales and marketing entity throughout the EU may also wish to use that entity to perform 'receipt and transmission' and 'execution' (transfer agency type services) in that entity.

3. An overview of the industry's appetite for the freedoms offered by the MCD, the efficacy of alternatives etc etc
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As part of the background work done to complete this report, we interviewed members of the wider Expert Working group representing 15 different fund promoters, from 6 member states

with total assets under management of over Euro 3 trillion, representing over 60 % of the AUM of European UCITS.

The following is a synopsis of the responses we received to questions relating to the UCITS Management Company.

How Many UCITS Management Companies do you run and how many would you ideally run?

In general, all respondents run multiple management companies as a direct result of their need for various reasons to have product domiciled in multiple locations. The majority of respondents confirmed that, if possible, they would reduce their number of management companies to just one. However, a number of respondents noted that whilst this was seen as desirable within their groups it would not, even if possible legally, be a priority.

Has conversion to UCITS III increased your group's interest in consolidating management companies? In the absence of this possibility has it resulted in a greater interest in fund consolidation?

The overwhelming response on this question was that the unavailability of a passport for the management company has not led fund groups to push consolidation of fund ranges using the means available (closure, redomiciliation and schemes of arrangement). However, several respondents noted that they have had to establish or re-establish management companies in jurisdictions where they have not previously had them. Whilst the cost burden of compliance with UCITS III has not been inconsiderable (in the range Euro 500,000 to Euro 1 Million per management company) it is believed that the major disadvantage has been in the duplication or thinning out of available resources leading to a worsening or at best neutral effect on the overall control environment.

Assuming your best resourced management company could manage UCITS across all of your fund domiciles without the need for a local management company for either corporate or contractual funds, would your group take advantage of this opportunity?

There was universal accord on this question. All groups would certainly look at the practicalities of doing this. Having said this, some respondents, as noted above, said whilst this would be desirable, putting it into place would not rank highly amongst their corporate priorities.

Would your group regard the development of centres of excellence for investment risk monitoring, regulatory reporting, and compliance as a benefit of a functioning management company passport?

There was a mixed response to this question. Most respondents were of the view that investment risk reporting should be centralised close to the asset management function wherever that is situate. Some respondents were of the view that regulatory reporting and compliance monitoring could only really be grouped in one centre of excellence if the group was operating only one fund domicile. Others believed that having centralised teams with multi-domicile expertise would offer scale and control benefits that could not be ignored.

Do you think the 'head office' principle described in Article 3 of the Directive should prevent a passporting management company performing all of the operational activities of the fund (except Depositary Bank functions) itself in its own Member State or through delegates in

Member States other than the domicile of the Fund ? why?; If not, how do you think the 'head office' principle could be adhered to in the absence of these functions being performed locally?

There was also a mixed response to these questions. One group of respondents agreed that the 'head office' principle should not prevent UCITS management companies performing the full range of CPM activities from their home member states for funds domiciled abroad. There was general agreement that the 'head office' concept itself may be redundant but a recognition that supervisors may insist on retaining some regulatory 'purchase' on 'their' fund's operations other than through the activities of the depositary or trustee.

Does your group see benefits in being able to passport portfolio management, investment advice and safekeeping of Units of UCIs in a management company? Generally is there pent-up demand for this? Have you or would you consider providing management company services from your ISD portfolio management company.

There was generally not much enthusiasm for the 'bolt-on' ISD services. Given the historical necessity to segregate ISD and UCITS management activities, the view was that there was currently no major driver towards use of management companies for the purposes of 'individual' portfolio management or, for that matter, use of an ISD firm for management company services (assuming that is possible). This was particularly so where the CPM service itself continues to be unpassportable.

What issues do you perceive with the system of cross-border delegation that exists today? Do you incur incremental VAT or other costs as a result of delegation? How would a management company passport change this?

Some commentators have suggested that the ability to delegate functions cross-border makes the ability to passport CPM services redundant. The clear response received was that this is not the case. Whilst delegation clearly works it does not remove the costs associated with running a management company which is responsible for supervising the delegate. Most respondents commented on the lack of homogeneity in delegation rules throughout the union. VAT did not appear high on most respondents' agenda and there was no one who believed that the passportability of a management company would improve or disimprove the VAT situation for collective investment schemes and their service providers. A number of respondents pointed to the forthcoming results of the review of the Sixth VAT Directive as possibly providing clarity on this whole area.

Some commentators have suggested that facilitating cross-border mergers will negate the need for a management company passport. What is your view?

Most respondents were of the view that this analysis is not correct and that the two topics are not related. Some did comment that streamlining of fund ranges through cross-border mergers would lead to a reduction of management companies – but merely as a by-product and that the two concepts are valid independently of each other.

Do you think that the now 'Core' MiFID activity of Investment Advice should also be available as a 'Core' activity for UCITS Managers?

There was widespread support for consistency in treatment as between UCITS Managers providing MiFID regulated services and MiFID firms. There was not widespread interest in the extension of the services capable of being provided by UCITS managers to all of the services specified in the MiFID.

Do you agree that 'marketing' (as specified in Annex A to the Directive) should include marketing of group product not managed by the management company providing the service? What about third party products?

There was general agreement that this activity should be independently passportable and that it should extend to the marketing of third party product.

Do you see any fundamental basis or need to maintain the domicile of common funds in the country of domicile of the management company. Does your answer change if the depositary/custodian bank domicile remains that of the fund?

No respondent saw a fundamental need to maintain this situation. There was general agreement that the domicile of a contractual fund could be determined by the management regulations / trust deed establishing the fund. This could specify that the domicile of the fund is that of the regulatory authority which issues its UCITS Certificate. There was also general agreement that a continuance of the requirement for the custodian bank/depositary to be located in the domicile of the fund was an important additional indicator of the nationality of the fund.

Do you see a need for greater clarification of the role of the depositary / custodian bank as a condition precedent to a functioning management company passport?

No. – the view is that having the depositary in the same member state as the authorising authority of the fund is sufficient to copperfasten the nationality of that fund. The regulatory authorities are in a position to obtain sufficient information on the activities of foreign management companies so as to reduce the importance of consistency in the role of the depositary which is subject to enormous regional variation.

Does the requirement that a management company not become a 'letter box entity' constitute a bar to an effective management company passport?

The clear view of respondents to this question was that it did not have to be removed. In the scenario envisaged by the respondents the requirement would be to have sufficient substance in all UCITS management companies but that economies of scale were achievable where these resources could be utilised across multiple fund domiciles.

4. Barrier Analysis and potential solutions

According to the feedback statement on the Green Paper on Investment Funds, approximately 75% of the 65% of respondees to the question in the Green Paper on Investment Funds about the need for further action on the management company passport confirmed that action was necessary. The Commission services noted however that over 50% of the contributors, including nearly all regulators who responded on this issue explained that such a passport gave rise to concerns regarding investor protection and efficacy of supervision.

We have analysed the barriers to the Management Company passport identified by the respondents to the Commission's green paper on Investment Funds. These barriers can be divided into 5 categories. Our responses to the points raised are contained in the following section.

Costs/ Savings

The objections raised in relation to costs and savings can be sub-categorised into three headings.

Increased costs for the depositary (travel, tax and legal expertise, secure information networks).

We believe this objection to be largely spurious. In many Member States the regulator not relying in any sense on the depositary / custodian to 'supervise' the management company of the fund. In Member States where this is, to an extent, the case we find that the cost objections put forward are not credible.

Savings potential already exploited via delegation.

As noted in the response to our questionnaire the industry view is that delegation is not a panacea. Having to maintain multiple management companies managing harmonised products in a number of member states is costly and inefficient. The savings potential is real.

No evidence that substantial savings will be achieved.

There is real evidence from members of the working group to suggest that the establishment and maintenance of a UCITS III management company in an 'exporting' country can cost between Euro 500,000 and Euro 1 Million. By centralising management company services in the best resourced management company these costs can be saved and, at the same time, substantial control enhancements may be achieved.

Investors

More difficult to address complaints to the management company (distance, language, unclear to who they should be addressed).

It could be argued that centralisation of management company functions in one location would improve, not disimprove this situation. It must be borne in mind that purely domestically focussed asset managers will have no interest in the management company passport and the issue simply does not arise in respect of these groups. For pan-European groups, there is no consistent model for dealing with complaints. In some groups, complaints are addressed to the nominated paying agent in each country into which the fund is passported and the language issue therefore does not arise. Other groups seek to route complaints to the centralised client relationship department with local language skills. Still others seek to route complaints through the depositary – in the domicile of the fund. Others have no defined complaints handling process. The Investor is of course free to, and will, address complaints to what ever group entity or regulator it sees fit.

Uncertainty about which authority is really responsible.

Under the model proposed in the Directive but not fulfilled, the Home regulator of the fund will be responsible for the regulation of the fund. The Home state regulator of the management company (if different) will be responsible for the management of the management company. In the event that the management company is providing CPM services into another member state, that member states' regulator should impose conduct of business rules on the passporting management company. This is no different to the situation with an ISD firm or Credit institution passporting its services into another member state.

Will delay redress

Again, the mechanism provided for passporting under the Directive is no different in most respects than that already existing for credit institutions and ISD firms. We are not aware of any particularities associated with CPM services which would prevent this model operating for them in the same manner.

Operational risks

More difficult for the depositary to perform its duties (distance, need to ensure that MC's decisions comply with regulations of the countries where the management company and the fund are located)

Again, this alleged barrier assumes that there is a common position on the supervisory role of the depositary bank vis-à-vis the management company. We know this is not the case. Again, the management company passport will only be of interest to pan-european asset management groups with multiple fund domiciles. This community utilises either in-house depositary banking services or the services of a group of service providers who are present in and conversant in the laws and regulations of every European fund domicile.

Supervisors

Will undermine the effectiveness of supervision, even if solutions are put in place, due to co-ordination difficulties and the organisational complexity of the resulting situation.

The working group members point out again the working precedents of the ISD and second BCD. Given that the depositary bank, fund administrator and registrar and transfer agent – the key control agents of the UCITS vehicle - will all be obliged to be located in the member state of the fund we do not see how any inherent difficulties in information exchange between supervisors will reduce the effectiveness of regulation which will effectively remain in the hands of the home state of the fund.

The Depositary

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Depository Passport

Scene setting

- Introduction : current situation

- From a legal point of view

The function of depository was introduced in the European Union as part of the legal framework of collective investment resulting from Directive 85-611.

Since that Directive was issued, no new regulation has been adopted providing a more specific definition of the depository's status and/or responsibilities.

Thus, a depository is defined in Europe by the Directive as an undertaking "*which performs the duties mentioned in articles 7 [safekeeping of assets] and 14 [protection role] (...)*".

It seems possible to consider that the depository has two missions:

- ❖ **Safekeeping the assets of the UCITS:**

The directive 85-611 notes that:

1. *A unit trust's assets [respectively, an investment fund's assets] must be entrusted to a depository for safe-keeping.*
2. *A depository's liability as referred to in Article 9 [respectively, in Article 16] shall not be affected by the fact that it has entrusted to a third party all or some of the assets in its safekeeping.*

- ❖ **Controlling the assets for both mission of safekeeping and trustee monitoring:**

The directive writes that:

A depository must, moreover:

- (a) ensure that the sale, issue, re-purchase, redemption and cancellation of units effected on behalf of a unit trust or by a management company are carried out in accordance with the law and the fund rules;*
- (b) ensure that the value of units is calculated in accordance with the law and the fund rules;*
- (c) carry out the instructions of the management company, unless they conflict with the law or the fund rules;*
- (d) ensure that in transactions involving a unit trust's assets any consideration is remitted to it within the usual time limits;*
- (e) ensure that a unit trust's income is applied in accordance with the law and the fund rules.*

- From a practical point of view

In some country, the functions which are defined under national legislation, mostly fiduciary in nature, for the depository, are considered as a **third function** (which can be carried out by a special entity). For example, in Austria, the depositaries are required to calculate the NAV; in Italy, the depositaries are required to review and to approve the NAV; in Germany, the depositaries are required to provide (and to take responsibility for) the portfolio prices that go into the NAV.

It is possible to note that the safekeeping (often known as "custody function") is relatively similar across EU Member States, with one major exception being the absence of an harmonised asset safekeeping definition clarifying in particular the underlying obligations in terms of returning the assets.

On the contrary, the “control function” differs widely in each Member States, each national regulator asking for different type of controls. The absence of a precise definition and role of the depositary at EU level has led to diverging transposition of the role and responsibilities of the depositary at national levels. Those differences tend to even increase, due to new national legislative initiatives mostly triggered by the development of the fund industry and the increasing complexity of products.

The depositary function plays an important role for **investor confidence**. Given the increased complexity and variety of funds (especially with UCITS III) the role of the depositary becomes all the more important and should not be jeopardized. The development of funds distribution on a cross border basis and, more generally, the development of a pan-European fund industry requires to ensure a consistent level of investor protection which would further contribute to investor confidence in non domestic products.

One of the issues addressed by the Green Paper is the possibility of creating a European depositary passport. Although the idea may be interesting in a long term, this is not practical at this stage, because the status, role and responsibilities of depositaries have not been harmonised.

Issuing a European passport without first having harmonised regulations would have negative repercussions:

- on competition, as the absence of a level playing field would hinder the development of a true single European market;
- more importantly on investors protection (in the event that a depositary is selected from a country that has less strict requirements in terms of oversight).
- and on investor confidence at the end.

Therefore, this report will try to analyse the **possible advantages of the harmonisation**, and to determine which elements could be harmonised, rather than speaking about a depositary passport.

1. **Definition: What would harmonisation of the depositary imply?**

At European level, a depositary’s tasks encompass both the notion of safekeeping assets and of trustee monitoring, but the status of depositary, its effective role and the extent of its responsibilities have been the subject of adjustments in the regulations of various member countries, resulting today in wide differences that make it difficult for the firms concerned to compete for business.

For example, the discrepancies included:

- differences in the power to delegate: possible functions, required prior formalities and/or oversight, etc.
- differences in liabilities in respect of the safekeeping of assets (e.g.: restitution obligation in France, an obligation that does not exist or is more limited in other member countries)
- the legal status of firms (for instance, an insurance or annuity company governed by the insurance code could be a UCITS depositary in France, whereas this was not possible in Luxembourg or Ireland); in Ireland the Depositary is not required to be a bank;
- differences in requirements applicable to minimum capitalisation, depending, *inter alia*, on existing options between various forms of business;

- use of a prime broker (depositories have fewer responsibilities with respect to prime brokers in Ireland than in France or Germany);
- differences in obligations for the oversight of UCITS (e.g. Germany depositories are required to recalculate net asset values of UCITS jointly with the management company, an obligation that does not exist in other member countries).

But there is a part of the Depository function that is already harmonised to a large extent (some legal questions aside): asset safekeeping and basic custody functions. These functions could easily be harmonised across the EU.

2. Rationale: what would be the advantages of an harmonisation

Contribution to the stability and strength of the UCIT label

The UCITS label is recognised and has won investor confidence. The depository function has played an important role in that respect. The increase complexity of funds (diversity and complexity of eligible assets for example) calls for an increased role of the depository to ensure maintenance of the high level of investor confidence.

A complement to facilitate development of the fund industry on a pan European basis

- **Facilitation of business:** it seems necessary to solve the difficulties of the branches (based in an EU member State) of banks which have their headquarters in other EU Member State. It is not explicit or clear that a branch is eligible to be a depository.
- **Facilitation of cross-border fund distribution**
A consistent level of investor protection across Europe would contribute to investor confidence in EU products globally and not only in domestic funds.
- **Risk mitigation improved**
Some harmonised rule across Europe would facilitate the controls of the depository and avoid operational errors. This may be important with the development of the management companies' passport.
- **Contribution to confidence between regulators**
Regulators rely significantly on the depository function to ensure investor protection. That is why in most European countries national regulators have taken strong interest in the definition and scope of controls and responsibilities of the depository. A harmonisation process on those key elements would contribute to build trust among regulators which would facilitate cross-border business generally.
- **Cost would be lowered although the depository cost remains a small part of UCITS total costs**
Some harmonised requirements in terms of controls and responsibilities of the depositories would enable the depositories to maximise economies of scale and optimise their operation costs on a pan European basis. Some (but likely not overly significant) costs reduction could be achieved.

3. Barrier inventory: What obstacles stay on the way of harmonisation?

The Communication of the European Commission¹⁹ on the "regulation of UCITS depositaries in the Member States" quoted a certain number of barriers, which are mostly still valid. Business practices also reveal other barriers.

3.1: Legal barrier

- The statute of EU Banks branches which act in another EU country.

UCITS III is silent on this and countries have different interpretations. Some countries do not allow the branches to be registered as a depositary.

- The permission for the Depositary to delegate to a custodian located in the EU, and chosen by the depositary.

Some national regulators authorise this delegation and some other not.

- Who is eligible to be a depositary?

Each Member State has different criteria. Even if some firms (credit institutions, investment firms, insurance company) are in general allowed to act as a depositary, other firms can be eligible. And it is possible to notice a strong dispersion in capital requirements.

- Depending on the Member State, the depositary may be subject to an obligation of result, or an obligation of means, in the performance of its prudential duties.

This has a direct impact on legal certainty. For example, only three Member State competent authorities seem to exclude "force majeure" as an extreme waiver of responsibility.

Legal uncertainty also results from the commingling of depositary-specific legal obligations and the broad civil case law. This is especially the case in jurisdictions, where the principle of the depositary's liability according to the Directive ("unjustifiable failure to perform ... or improper performance") is, explicitly or not, subject to limitations or derogations. Retail investors actually bear a risk (and costs) which are a priori hidden to them.

3.2: Absence of definition

The meaning of 'asset safekeeping' is not harmonized:

Safekeeping the assets of a UCITS is the first *raison d'être* of the depositary. But the Directive does not specify the content of its responsibility: The various interpretation of Member States range from a simple prudential control over possible external custodians to a full-fledge "keeper" function bound by obligations towards the manager and the investors, independently from its controls.

Depending of the level of responsibilities attached to the concept of asset safekeeping, the depositary organisation and business model will differs. If the depositary is fully responsible vis a vis the fund or the asset manager and needs to return the assets, the depositary will be reluctant to delegate the custody function to a third party which would not have the same responsibilities.

¹⁹ COM (2004) 207 final, 30 March 2004

Across Member States, the mission of asset safekeeping may, or not, necessarily involve a custodian sub-function. Custody is subject to significant economies of scale and requires considerable investments in computer systems distinct from those of depositary control. A second issue which differentiates Member States is whether or not the depositary is really subject to an obligation to return the assets, or may limit its liability.

3.3: Terminology barrier

The differences across Europe in the meaning of terms relevant to the depositary function currently create confusion and possibly additional costs (example: the definitions of interest or of value-added are not harmonised).

4. Elements of solution to the identified barriers

To solve the barriers, the professionals need to work with the regulator and the Commission (see point 5 for more details).

5. Proposed measures in detail: What measures should be taken in order to efficiently implement the solution(s)?

It seems possible to distinguish the short term and the long term solutions.

5.1: The short term solutions could be:

- The ability of branches of EU banks to act in another EU country (a)
- Permission for the Depositary to delegate to a custodian located in the EU, and chosen by the depositary and under its responsibility (b)

(a) Permission for the branch of a EU bank to act in another EU country

To facilitate the business and avoid discrimination in Europe, it is necessary to solve the difficulties of the branches (based in an EU member State) of banks which have their headquarters in other EU Member State. In some EU States, this branch is not allowed to be the depositary for the funds in its market.

Permission for the branch of a EU firm to be located in another EU firm (extract from the Communication of the Commission (COM 2004 207)

Countries	Cases where the depositary has his registered office in the Member State where the UCITS was authorised	Case where the depositary only has a branch in that Member State
DE	80	2
ES	118	5
FR	87	none
IE	23	5
LU	65	6
UK	7	none

(b) *Permission for the Depository to delegate to a custodian located in the EU and chosen by the depository*

Advantage: an important scale effects resulting in lower units costs for safekeeping/custody functions. To enable this proposal to be actually implemented and to maintain the existing level of investor protection, the delegate should contractually agree to assume the same responsibilities as the depository, with regards to asset.

5.2: The long term solutions

The other barriers, quoted in the point 3 of this report (Barrier inventory) have to be studied more in details, together with those identified by the Commission in its Communication²⁰ on the “*regulation of UCITS depositaries in the Member States*”, in order to improve the cross border business. The study should be focus on two of these barriers.

(a) *The eligibility to be a depository*

The depositaries do not have the same statute in Europe. Investment firms, credit institutions, insurance companies, but also other firms can be registered as depository in an EU country.

The typology of eligible institutions (extract of the communication of the Commission of March 2004²¹)

DE	ES	FR	IE	LU	UK
Credit institutions	Credit institutions, investment firms	In practice: <u>supervised institutions</u> in general (credit institutions, investment firms, insurance undertakings...)	In practice: <u>supervised institutions</u> in general	Credit institutions	In practice: <u>supervised institutions</u> in general

Therefore, we can note a strong dispersion in capital requirements: For example, across even within one category –credit institutions– minimum capital requirements vary from €5 million to € 100 million.

A harmonisation of the capital requirements (and maybe broadly of the statute of the depository) appears to be necessary in order to have a level playing field.

Therefore, we recommend that the Commission harmonises the capital requirements of the depositaries.

²⁰ COM (2004) 207 final, 30 March 2004.

²¹ Idem.

(b) Need to study the barriers described (above) and those identified by the Commission in its Communication on the "regulation of UCITS depositaries in the Member States", in order to improve the cross-border business.

A study seems necessary for the legal barriers concerning the obligation of result, or an obligation of means of the depositary, in the performance of its prudential duties (only three Member States seem to exclude "force majeure" as an extreme waiver of responsibility.). To achieve the potential economies of scale on the custody side, the definition of asset safekeeping for all types of assets need to be studied (and harmonized) across the EU. This is already achieved for classical types of assets such as equities and bonds but not for other asset classes. The underlying obligations will also need to be studied, in order to determine if a harmonization would allow the custodians to rationalize their custody platform across the EU including the type of reporting required.

Harmonization of the responsibilities could also allow potential delegation to external parties which will potentially deliver further economies of scale and costs reductions.

Generally differences in terms of liabilities should be removed. For example in respect of the safekeeping of assets, there is an asset restitution obligation in some countries, whereas this obligation does not exist or is more limited in other member countries.

We recommend that the Commission studies the existing barriers and solves the issues relating to the differences of definitions of asset safekeeping.

6. Possible supervisory/investor protection objections and other drawbacks

Our proposals (not to ask for a depositary passport but for a harmonisation of key points) appear to be modest.

However, regulators which do not respect our recommendations (ie the ability for the branch of an EU bank to be located in another EU firm, or the possibility for the depositary to delegate to a custodian) might not welcome our recommendations.

7. Feasibility and costs identification

- Is there any risk that the costs/difficulties linked to the implementation of the above solutions could outweigh the advantages?

We do not see any risk that the costs/difficulties linked to the implementation of the above solutions could outweigh the advantages.