Report of the Expert Group on Investment Fund Market Efficiency

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European Commission
Internal Market and Services DG

EXPERT GROUP ON INVESTMENT FUND MARKET EFFICIENCY: REPORT TO THE COMMISSION

This report reflects the outcome of discussions within the Expert Group on Investment Fund Market Efficiency over the period February – June 2006. During this period, the group met four times on the basis of an evolving draft of the report and its appendices. In the very limited number of instances where points of view could not be reconciled, this is made clear in the body of the report. The report does not necessarily reflect the views of the organisations to which the group members belong.

The role of Commission staff in the groups was to facilitate discussions – by providing secretarial support in organising and hosting the meetings, and contributing to put together the report. Consequently, the expert group's report should not be construed as reflecting the position of the Commission or of its services.

The Commission services consider that the report provides a comprehensive assessment of the extent to which the existing EU legislative framework curtails the efficiency of the European fund industry. It provides a clear statement of the main expectations and concerns of the industry and sets out recommendations for harnessing the full potential of an integrated single market for investment funds.

The report's analysis and recommendations, as well as other stakeholders' reactions to those, will be taken into account by the Commission when assessing the options to improve the working of the framework for investment funds. The Commission plans to publish the results of this assessment in November 2006. At the same time, a White Paper will define the concrete actions needed to drive forward improvements in the investment fund area.

REACTING TO THE REPORT

The Commission services now wish to submit the assessment and views of the expert groups to wider scrutiny and open debate before developing a basis for a formal position. To this end, Commission services have organised an Open Hearing in Brussels on 19th July. Stakeholders are also welcome to send written comments to the below address before September 20th. Reactions will be published on our website unless a confidential treatment is explicitly requested.

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The appendices to this report can be found at:

http://ec.europa.eu/internal_market/securities/ucits/index_en.htm

- Executive summary -

UCITS have witnessed a phenomenal success over the past decade, with funds increasingly being sold on a cross-border basis and outside of the EU. Investors and regulators alike take confidence in the protections that are built into the Directive. However, the industry is now at a crossroads: cross-border competition is becoming keener, product innovation is accelerating and new non-UCITS savings products are increasingly attracting investors

Long time-to-market delays, barriers to economies of scale and difficulties to organize value-chain services on a pan-European basis are holding back the industry. Some of these inefficiencies result from outdated or prescriptive provisions of the existing UCITS Directive that create a rigid framework for one of the most highly regulated financial services products; the rest are due to the absence of enabling mechanisms to help the industry to respond to new challenges.

Following the Green Paper on investment funds, the European Commission established an Expert Group on Investment Fund Market Efficiency to gather the views of market practitioners on how to make the EU framework more relevant. This Expert Group was mandated to advise the Commission on cost-effective ways to support a more efficient organisation of the European fund value-chain. This group has not looked at issues regarding the scope of the product passport or rules relating to fund composition and investment policy, as these issues are under examination by competent authorities.

There is a wide-ranging consensus on the obstacles to the further successful development of European fund markets. The Expert Group report provides the first set of clear, detailed and workable recommendations on 'how' to remove those barriers.

<u>Reduce administrative delays in getting investment funds to the market:</u>

Obtaining authorisation in the country where the fund is domiciled can be a lengthy process, followed by additional time spent notifying funds for sale in other Member States. This situation penalizes UCITS with respect to other, competing products that provide less investor protection. To redress this imbalance, the Group recommends:

- amending the UCITS Directive to align its authorisation and notification rules along Prospectus Directive timescales, meaning authorisation of funds in 20 business days and electronic regulator-to-regulator notification taking a maximum 3 days.
- revising the simplified prospectus so that it becomes a fully and automatically recognised document containing key disclosures for investors. The simplified prospectus (including any translations thereof) should be communicated as part of the cross-border notification and should not be the subject of further examination by the host authority.

Enable the rapid and efficient merger of funds:

The UCITS Directive does not provide any mechanism for merging investment funds. Regulatory blockage, differences between national company laws, investor protection rules and taxation imbalances stand in the way of a much needed consolidation of the investment fund landscape. In order to allow for cross-border fund mergers, the Expert Group recommends:

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

Allow the centralised (pooled) management of assets owned by different funds:

A number of Member States allow the collective or pooled management of assets gathered by two or more funds. This helps to reduce costs and make fullest possible use of scare management resources. In order to generalize these commingling possibilities at a European level, the Expert Group recommends:

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

Breathe life into the management company passport:

Fund managers should be able to provide core management services to funds domiciled in other Member States. This would pave the way for a rational organisation of the industry based on specialisation. The UCITS III amendments tried to translate this idea into practice but fell short. The Expert Group recommends that the issue be revisited by:

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

Provide more freedoms for the depositary:

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

- enabling branches of banks from other Member States to act as a depositary;

- allowing the depositary to be free to delegate asset-safekeeping to custodians in another EU Member State, subject to the custodian complying with the depositary's local regulations on a contractual basis.
- In a longer term, the Commission should 1) harmonise the capital requirements of depositaries and 2) study the barriers to further harmonising the role and responsibilities of the depositary

This report provides a set of practical solutions to remove the legal and regulatory inefficiencies that stifle the successful development of European fund markets. As UCITS is a product Directive, slight modifications to the legislative framework are necessary to allow the fund industry to evolve. Some of these will require changes or additions to the existing Directive; however, none involve tampering with core features or the scope of the Directive.

Nevertheless, it will be important to continue to test the form and impact of the envisaged changes as they take shape. This will keep adjustment and compliance costs to a minimum and ensure a coherent regulatory and commercial outcome.

What is required now is a sense of urgency. Valuable time has already been lost, as some of these issues have been debated for the past several years. As such, the Expert Group strongly recommends that the legislative changes are completed in a Lamfalussy style and subsequently implemented by Member States in a homogeneous manner within the next three years. Lengthier delays risk compromising the future success of the EU funds industry.

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The Asset Management Industry: recent evolution and main challenges

1. *Building on success*

Phenomenal success of UCITS over the past decade

The UCITS Directive[1] laid the foundations for the emergence of a vibrant and globally competitive investment fund industry based in the EU. This market has quadrupled in size over the past decade, to more than 30,000 UCITS with € 5 trillion in assets under management at the end of 2005[2].

Cross-border business takes root

Funds marketed on a cross-border basis play an increasingly important role in this industry. The UCITS passport paved the way for extensive cross-border marketing of funds. Nearly 5,000 UCITS (or 17% of the total) are widely sold cross-border, an increase of 50% over the past three years[3]. This trend is set to continue, as net sales of cross-border funds have outpaced sales of domestic funds over the past few years[4].

Efficient use of the passport heralds price competition, investor choice and performance

The growth of cross-border funds has important implications for market organisation and performance. Managers can serve an EU-wide investor base with a single fund per asset class/investment strategy, potentially creating opportunities for important scale and efficiency benefits. Moreover, distributors can provide research and recommendation for funds used across Europe. Increased presence of non-domestic products should translate into price competition, thereby driving total expenses towards the lowest levels observed in the EU. These two mechanisms should heighten competition, drive down costs and improve net returns to investors, provided that they are allowed to work properly.

UCITS regulatory concept recognized worldwide

UCITS funds are not only being sold within the EU. The UCITS regulatory concept has become the de facto international gold standard. As such, UCITS authorisation has often been sufficient to allow EU fund managers easier access to markets in Switzerland, Asia and Latin America. However, access to these jurisdictions could be much improved if there was a more structured form of mutual cooperation.

Investor protection hard-wired into UCITS

Regulatory and investor confidence in UCITS stem from the protections that are built into the Directive. These include rules on investment limits, strong home country authorization and regulation and oversight by an independent depositary. The fact that the product itself is reviewed and authorised by a public authority has inspired confidence in investors and host country regulators for the past two decades.

UCITS has stood the test of time but needs to evolve

The UCITS model has clearly been a successful launching pad for the EU fund industry. However, a rapidly changing environment is placing strain on the UCITS framework.

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[1] Directive 85/611/EC on the coordination of laws, regulations and administrative provisions relating to Undertakings for Collective Investment in Transferable Securities adopted on 20th December 1985.
[2] Quarterly Statistical Release, EFAMA, March 2006; data as at end 2005.
[3] Pan-European UCITS Distribution 2005, PwC and Lipper, 2005; data as at end 2004.
[4] EFAMA, March 2006.

2. *Responding to changing investor needs*

Retirement needs are radically modifying the demand for investment products

The demand for investment products has rapidly evolved in response to structural trends, such as the ageing of the population - witness the development of private pension plans in Italy (TFR) and the introduction of individualised work-related schemes in France (PERCO). These new actors are demanding investment products that match their particular needs and time horizons. Retirement needs as a whole are driving investment management towards an asset and liability-driven style.

Investors are becoming increasingly sophisticated on the whole

At the same time, retail investors tend to have a more sophisticated understanding of the investment products on offer. This is due to greater access to financial information and an increasing reliance on professional intermediaries to make investment decisions or give advice. As such, the investment market has opened up to a broader product range, notably those that include embedded asset allocation (flexible, lifecycle, etc.) or provide an income stream. Increased competition has led to compressed product innovation cycles and stronger cost pressures, as investors expect lower total expenses.

UCITS need to respond to these pressures to remain competitive

UCITS must respond quickly to these pressures if they are to remain competitive, as well as attractive to new investors such as pension funds. Should this not be the case, other investment products will rapidly fill the gap.

3. *Competing with other investment products*

Increased sales competition for UCITS from less-regulated products

UCITS increasingly compete with other investment products such as unit-linked life insurance contracts, investment certificates and structured products and other collective investment schemes for long-term investment. Although there are differences in product features, performance, risk, regulation and tax, these alternative vehicles are increasingly attracting investors.

Risk that investors choose such products even though less protection and disclosure

Compared to products such as certificates or structured products, the UCITS framework imposes onerous risk and cost disclosures. The regulatory imbalance is not limited to disclosure: a securities/certificate issue can be authorised in a fraction of the time required for a UCITS. Once authorization is received, these products can be passported via the Prospectus Directive and brought to market significantly quicker than a UCITS. In addition, while investment advice and dealing services for UCITS will be governed by MiFID[5], the rules on insurance sales are not covered by the same level of regulation.

Need to improve UCITS market efficiency without losing investor protection

Uneven disclosures and conduct of business protections put the fund industry on an unequal footing compared to other financial services. These issues call for serious regulatory engagement. There should not be any dilution of the regulatory safeguards that have underpinned the global success of UCITS - good disclosures, soundly regulated products, and properly policed distribution. However, there is a pressing need to improve market efficiency in order to compete successfully in this crowded market.

[5] Directive 2004/39/EC on Markets in Financial Instruments

4. *Giving the fund industry the tools to meet the challenges*

The fact that UCITS is a highly regulated product has undoubtedly contributed to its success. However, the UCITS industry cannot completely ignore the changing circumstances mentioned above. Asset management clearly needs to adapt and react to this new environment; however, the fact that UCITS is a product Directive means that the legal framework must be changed prior to any such evolution.

UCITS are highly regulated using product-based legislation

If the UCITS framework does not evolve in line with market needs and investor demand, investment funds will no longer be able to compete with the alternative investment products.

The Expert Group has identified a limited number of inefficiencies related to the legal and regulatory framework that are currently stunting the investment fund industry's development. As shown below, these inefficiencies can be removed by modifying existing UCITS law or adding provisions to the legal framework where none currently exist.

Need greater regulatory flexibility to allow industry to respond to the above challenges

Inefficiency 1: Lengthy procedures in bringing new products to market.

Speed of new products to market is crucial in a modern financial system. Compared to competing products and investors' expectations, UCITS suffer from extensive time-to-market delays. Long home State authorisation periods are followed by excessive bureaucracy when notifying and selling funds in other Member States.

Long time-to-market delays due to major inefficiencies in cross-border passporting of funds

Although the notification procedure was designed to facilitate the pan-European marketing of UCITS, it has become legally and administratively complex. As a result, investors have less choice, the industry is denied opportunities and both suffer higher costs. Chapter I presents the Expert Group's proposals to resolve the current problems with authorisation and passporting.

Inefficiency 2: Unexploited economies of scale

The European fund market is littered with many small, underperforming funds as well as clone funds from the same fund sponsor. These are relatively costly to run and absorb scarce and relatively expensive resources[6]. As such, economies of scale are unexploited and costs to investors are unnecessarily high.

Unrealized economies of scale due to obstacles to fund consolidation

This situation persists because of the absence of efficient mechanisms for amalgamating assets of smaller or clone funds into larger, more efficiently run operations. The commercial need to continually add new products only exacerbates this problem, and a lack of consolidation can hinder the rationalization of the asset management industry as a whole.

This report describes two promising and complementary solutions – fund mergers and asset pooling - that have already been successfully road-tested in some countries. In order to boost market efficiency and potentially lower costs to

[6] "Fund expenses comparison for US and Europe", Lipper / Fitzrovia, September 2005.

investors, the industry should be able to perform these operations on a cross-border basis and in a tax-efficient manner. Chapters II and III present concrete recommendations to facilitate an orderly consolidation of the European fund landscape while, at the same time, maintaining investor protection.

Inefficiency 3: Barriers to the cross-border provision of services

The UCITS framework artificially imposes a geographic organization of the value chain, as all funds must have a local depositary/custodian and a local management presence. As a result, costs are unnecessarily duplicated across fund domiciles, the industry is prevented from reaping specialization and efficiency gains and operational risk is increased.

Fragmentation of the value chain is imposed by regulation

More flexibility is needed to provide management company and custody services across borders. Chapters IV and V explain how to provide this much-needed flexibility for management companies and depositaries/custodians without sacrificing investor protection or effective supervision.

Inefficiency 4: Non-standardised fund order processing

The cross-border processing of fund orders is characterised by a high level of fragmentation at both trading and post trading in the transaction value chain. There is no pan-European fund execution and processing life-cycle in a fast growing environment[7]; such operations are often conducted manually in domestic markets. This results in high operating costs and considerable operational risks.

Other points mentioned in Green Paper do not require framework changes at this time

The fund industry is in the process of developing pan-European initiatives to deliver standardised fund order processing[8]. Consequently, the Expert Group does not believe that there is a role for public authorities in this process at this stage.

Inefficiency 5: Tax barriers to fund operations

Tax is a key driver in the investment fund market, including but not limited to its importance in the total return for any individual client. A lack of tax harmonisation across Europe can create inefficiencies and barriers to the single market in investment funds.

Insufficiently aligned tax structures create inefficiencies and barriers to single market for investment funds

A properly integrated market in investment funds needs further convergence in the tax treatment of funds and investors. However, except for the case of the taxation of fund mergers (see chapter II), the objective should not be to launch new initiatives aimed at tax convergence in Europe. Nevertheless, the Commission should take immediate action where there are identified breaches in existing treaties[9].

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[7] Net sales in European funds reached a five-year high at 31st December 2005 with subscriptions of € 365bn for that year (Feri Fund Market Monitor, February 2006 issue).

[8] The EFAMA Fund Processing Standardization Group, established in 2003, published its recommendations in February 2005.

[9] In this respect, the report by PWC and EFAMA 'Tax discrimination against foreign funds: Light at the end of the tunnel' offers a comprehensive analysis of cross-border tax discriminations for investment funds.

Concluding remarks:

Removing bottlenecks key to increase the efficiency of the industry

Gaps in the single market framework impose a heavy burden on the fund industry and its investors: reduced investor choice, untapped economies of scale, unexploited specialisation benefits, greater operational risks and higher costs. Ultimately, all of these inefficiencies result in reduced net returns for investors.

Removing these inefficiencies will pave the way for reorganisation and greater efficiency. More importantly, it should unleash new competition, thereby leading to sustained product performance and innovation.

Targeted modification to the UCITS framework must be undertaken without delay

The following chapters provide a more detailed explanation and justification for the Expert Group's recommendations. A targeted modification to the UCITS framework will be needed to enable many of the recommendations to take effect, followed by some adjustment and repositioning by market participants. Solutions should continue to be tested for effectiveness, including avoiding unnecessary compliance costs.

A timely response by authorities is vital for the development of the industry

The Expert Group urges EU institutions and Member States to constructively engage in these recommendations, as the potential benefits are too important to forego. A timely and effective response within the next three years is needed in order to allow the fund industry to continue to develop and provide efficient and effective investment solutions for European investors.

I. Getting products to the market more quickly

I.1. What is authorisation and notification?

The UCITS Directive provided the first financial services passport. As services had not been harmonised at an EU level, agreement for the free marketing of investment funds across EU States, relied on harmonisation of the fund product. To provide comfort between States, the product itself was authorised by its home State's Competent Authority (CA). Once authorised in its home State, a UCITS was entitled to be marketed in another Member State, subject to a notification procedure whereby the fund manager filed documentation with the host CA.

UCITS, the first financial services passport

I.2. Where do we stand?

a. Authorisation for sale in the home Member State

Today authorisation procedures have become in some Member States long and cumbersome procedures. They are implemented in ways that impede the industry from exploiting the opportunities offered by a dynamic financial environment. The Directive states no maximum time for how long this procedure should take. Little account is taken of the fact that the operator is subject to home State authorisation including prudential rules on administrative and accounting procedures, conflicts of interests, compliance and risk management. Thus legal documentation prepared by an operator is double-checked by CAs resulting in increased cost and delay with little investor protection benefits. Additionally, practical requirements frequently do not take advantages of new information technologies. The arrangements for filing authorisation documents remain broadly paper-based.

Long procedures impede the industry to exploit opportunities and to compete with other financial products

The full consequences of this situation are not easy to quantify. While the time spent in preparing the files could be estimated, the uncertainty as regards to the duration of the procedure can have equally harmful consequences that are not easy to assess. Delays in launching a fund lead to missed opportunities. These can be particularly important in the case of innovative products[10]. The problem is compounded when the product is not just aimed for the national market but is part of a pan-European marketing strategy.

Delays lead to missed opportunities

b. Notification for marketing in another Member State

The UCITS notification procedure provided minor powers to host authorities regarding the marketing and advertising of incoming UCITS. However, it has become a byword for bureaucratic interference and hassle.

The need to comply with different Member State's requirements and to translate documents into other languages is a costly burden on the shoulders of the fund industry and its investors[11].

A costly procedure

[10] Many of the new strategies and products are likely to be most profitable to those who have 'first mover' advantage.

[11] See "A harmonised, simplified approach to UCITS registration", EFAMA/IMA April 2005.

As regards translation, provisions in the Directive are ambiguous. The Directive does not clearly indicate which documents need to be translated or when they are needed (i.e. when filing the notification request or before distributing the fund).

Why has the simple notification procedure foreseen by the Directive degenerated into such a burdensome process? Host Member States have overstepped the possibilities offered to them by the residual powers that they have in virtue of Article 44 of the UCITS Directive, which basically limits powers to checking marketing arrangements and requiring certain facilities to be put in place. Thus, the notification has almost become a second authorisation procedure in many countries.

Notification has become a re-authorisation procedure

Distrust among regulators and the growing complexity of the products have contributed to this outcome. Documents in addition to those mentioned in the Directive, as well as the inclusion in those of information re. national marketing arrangements are sometimes requested. Mere changes to prospectuses or the creation of new sub-funds often trigger the need to recommence the full-blown notification procedure.

c. What is the impact of these delays on the fund industry?

Both uncertainty and long delays seriously handicap the fund industry when competing with other financial products offering similar features. The table below summarises the current situation.

Directive→ Procedure ↓	UCITS	Prospectus	Life/MiFID
Authorisation	No harmonised maximum 2–4 months (on average)	20/10 days	None
Notification	2 months	next day (max. 3 days)	On request

The table highlights the anomaly that the product with the most investor protection characteristics takes longest to reach the market. The regime effectively encourages firms to push less well regulated products to circumvent these rules. It also undermines the relevance of the UCITS concept and the credibility of the passport – for no obvious benefits.

Encourages the marketing of less regulated products

I.3. How can we improve the situation?

The primary focus of the Expert Group was to look for a solution that maintained the UCITS 'brand' identity of an investment product with high standards of operational safeguards and transparency. However, it was also important to improve the product's 'time to market' so as to enable it to better compete on a level playing field in the market place.

Time to market needs to be improved

Two alternative solutions were considered by the Expert Group. 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.

Relying on a service passport might conceivably result in a faster time to market for the UCITS product, as regulatory approval would only be required for the service provider and not for each fund it manages. However, this type of self-regulation could pose several problems, notably for the perception of the UCITS brand and with respect to MiFID legislation (see the relevant Appendix to this section for more details).

A service passport risks to change the perception of the UCITS brand

Explicit regulatory approval, part of the UCITS brand, should therefore remain part of the process. With this in mind the group looked to see how the principles of the Prospectus Directive could be adapted for the UCITS Directive. Therefore the Expert Group would like to propose the following blueprint. Further analysis of some of its implications is provided in the Appendix.

Principles of the Prospectus Directive to be used as a model

The Expert Group's proposals are to amend the UCITS Directive:

a) at Article 4 to introduce a maximum initial home State CA authorisation time of 20 business days together with material changes to that authorisation (which includes adding additional sub-funds to an umbrella structure) subject to a 10 day maximum;

b) at Article 46 to require a home CA to host CA notification and bring the host State notification time down to a maximum of 3 days; and

c) at Schedule C, (and related Articles) and Article 44 to reposition the simplified prospectus as a summary prospectus. Using this simple, short document, which will be a detachable part of the full prospectus, as a marketing document will satisfy product disclosure requirements to the end investor (i.e. its use as a marketing document switches off host State marketing rules)

Initial Authorisation by home Member State authority

The home CA will have 20 business days for the authorisation of the initial product structure[12]. The UCITS operator must provide the home CA fund rules/instrument of incorporation full prospectus (if not part of the fund rules/instrument constituting the scheme)[13] and summary prospectus with a statement confirming compliance with the Directive prepared by the fund's operator.

If the application is incomplete or the requirement for supplementary information is requested on reasonable grounds by the home CA (which might be needed for more complex fund strategies) the time limit only starts applying once such additional information as requested is provided. However, the home CA must notify the UCITS operator of all such facts within 10 business days of the receipt of the application.

Subsequent Authorisation

The home State CA has 10 days to approve a change to the prospectus and fund rules/instrument (if applicable) which would include, in the case of umbrella structures, the addition of a new sub-fund. An amended or additional summary prospectus will need to be provided as relevant. As with the initial authorisation process, a requirement for supplementary information will delay the start of the time limit until such information has been provided.

[12] The product structure being defined as the overarching structure of the UCITS – be that a single fund in its own right or an umbrella structure.
[13] Note that the position with regard to UCITS Article 29 would be maintained.

Notification of UCITS for marketing in another Member State

The home CA should within three days of an authorised UCITS request (or, if the request is submitted at the time of the draft documents, within one day after authorisation), provide the relevant host CA with an electronic certificate that the UCITS product is authorised. Further to this, the host State should not undertake any approval, vetting or administrative procedure relating to these documents. Notification should be done electronically which could include a link to the relevant documents on the home CA website. The home CA would also be under a duty to notify the firm immediately, once the notification to the host CA had been undertaken.

Notification of subsequent changes

The notification process for any subsequent change follows the initial notification above, i.e. from home CA to host CA within three days of the approval of the change.

Summary Prospectus

The simplified prospectus is repositioned as a summary prospectus. As with the Prospectus Directive, this summary prospectus would form a detachable part of the full prospectus with both useable independently. The summary prospectus should, in brief non technical language convey the essential characteristics of the fund structure and each relevant sub-fund if the structure is an umbrella fund. It should have a flexible format and current requirements for use of audited information should be dropped to allow it to be more up to date.

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. It should provide risk warnings (including those on liability) and be limited in size. Specifically civil liability attaches only if the summary is misleading, inaccurate or inconsistent when read together with the other parts of the full prospectus, as per the Prospectus Directive.

Language

Article 47 would need amending so that where the UCITS product is sold in the home State only, the fund documents required for authorisation should be drawn up in a language acceptable to the home CA. Where the product is sold in a host State the documents written in the language of the home State should be acceptable. As with the Prospectus Directive the decision to make these documents available in the language of the host State or a language customary in the sphere of international finance is at the choice of the UCITS operator.

However, the host CA could request the summary prospectus to be translated into its official language(s). Host CAs should provide language requirements for the summary prospectus on their website. The translation should not be pre-checked by the host CA thereby delaying the selling of the fund. It would be up to the product provider to ensure that it complies with the translation requirements meaning it may be open to regulatory sanction if the translation results in the document being misleading. The product provider will submit the translated version of the summary prospectus to its home CA along with its notification request.

II. Facilitating UCITS mergers

II.1 What are mergers?

A **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 fund[14].

Ability to consolidate two or more funds

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 proposal B below).

II.2 Why do we need them?

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 funds[15]. 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)[16].

EU funds' average size is too small

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 exploited[17]. 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.

Economies of scale cannot be exploited

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 vary across countries, and investors have to access funds in different countries through multiple entry points. A single investor holding funds from the same fund provider could potentially be subject to a multitude of transaction processes (operations and administration).

Fund proliferation and complex fund ranges cause confusion

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 proliferation[18]. Investors and companies alike cannot reap the full benefits of

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[14] Defintion 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

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

[16] Ibid.

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

[18] 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.

such operations if cross-border mergers of funds are not possible. Nearly one-quarter of all funds were merged/closed over the past three years as the result of almost exclusively domestic fund mergers[19]; however, this is insufficient to achieve full economies of scale in an industry that is increasingly European, if not global.

Lack of a framework is hindering rationalisation

The UCITS Directive does not explicitly state whether 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.

Alternative techniques are complex and time consuming

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 domestic 600 mergers since 2003 in the French market alone[20]. A detailed comparison between schemes of arrangement, redomiciliation and « true » cross-border mergers of funds can be found in the relevant Appendix to this section.

As cross-border redomiciliation and schemes of arrangement depend upon individual regulator acceptance, they have only been practiced between a limited number of domiciles[21]. 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 there is clearly an urgent need to rationalize fund ranges in order to improve market efficiency, merging funds cross-border has proven to be a particularly challenging and expensive exercise. 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.

Taxes are a strong disincentive

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 funds[22]. It must be noted, however, that even domestic fund mergers can have negative tax consequences for cross-border

[19] Data Digest 2004 / 2005 / 2006, Feri Fund Market Information, April 2004 / March 2005 / March 2006

[20] Response to Green Paper, Association Française de la Gestion Financière, November 2005.

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

[22] "Tax discrimination against foreign funds: light at the end of the tunnel", PwC and EFAMA, November 2005

customers (see Appendices).

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.

II.3 How do we get there?

Need for a legislative framework that provides equal level of investor protection

The Expert Group recommends creating a legislative framework for fund mergers that covers all UCITS, including corporate and non-corporate funds[23]. 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. 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.

Amendment of the UCITS Directive required

In order to instate this freedom, two options exist: a) changing the UCITS Directive or b) drafting a separate new Directive. The Expert Group considers that 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 to address tax concerns.

In advance of 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.

Respecting investors rights

In defining its proposals (see box below), the Expert Group has spent a long time considering investor protection and regulatory concerns. Within the proposed fund mergers 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 not to 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)

Clear regulatory responsibilities needed

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

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

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.

Important benefits for investors

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 TERs[24]. Finally, investors would have simplified operations and administration, as they would access mutual funds through a unique entry point.

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

The Group's proposals to implement a UCITS merger framework are detailed below. These proposals will require minor modifications to the UCITS Directive, accompanied by a new Tax Directive so that investors do not systematically suffer adverse tax consequences from fund mergers (either directly or indirectly).

A. <u>Modifications necessary to the existing UCITS Directive</u>

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.

i) Definition of fund mergers

Article 1a 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.

[24] Lipper / Fitzrovia, September 2005 and "Report on mutual fund fees and expenses", Securities and Exchange Commission, December 2000.

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 in the UK).[25]

ii) Recognition of the right to merger UCITS cross-border

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.

iii) Apportion 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 statute 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

iv) 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 depository (or depositories, if more than one) will then be responsible for the asset transfer according to one of the methods specified in 1.3.2, and will also conduct a verification of the asset value.

v) 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.

vi) Information given to investors

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 :

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[25] 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.

[26] 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.

[27] European Fund and Asset Management Association

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

- 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[26]. However, this would only imply a vote if required by local law. Rather than 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.

vii) 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 case should be more than 75% of those voting. A detailed comparison of current voting practices in selected fund domiciles can be found in the Appendices.

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.

viii) 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[27]. Legislation regarding these points should not be necessary.

B. 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 limit any adverse tax implications for UCITS-to-UCITS mergers, be it for taxation of investors, funds or investments held within a fund.

Such a Directive would principally benefit investors, as they suffer the greatest tax-related consequences from fund mergers, either directly or indirectly. As shown in the attached analysis (see Appendices), 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 investors[28]
- 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 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.

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.

III. Action 3: Allowing pooling techniques

III.1 What is pooling?

Ability to manage combined assets

Pooling (known generically as commingling) techniques allows assets to be combined into a common account for the purpose of investment management and custody. Specifically, it will allow the following functions to be performed collectively:

- 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.

Widespread technique

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

No investor protection risks

It is important to note that while pooling appears complex, it does not result in a reduction of transparency or a diminution of investor rights. It is a technique which permits lower-cost asset management and should be viewed in this light. These savings accrue both directly to the fund and to the asset managers.

Two commingling situations: virtual and entity pooling

The Group has focused on two different situations of commingling:

o "Virtual Pooling" refers to 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.

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

Virtual pooling is heavily dependent on accounting and custody technology specific to virtual pooling provided by service providers, who must be able to perform daily "rebalancing" across all participating accounts to reflect dynamically changing ownership.

- "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.

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

  Entity pooling, in contrast to virtual pooling, is not dependent on a specific technology, but can operate within the confines of standard accounting and custody technology for investment funds.

  "Master Feeder" refers to a form of "Entity Pooling" characterised by a "one to one" relationship between the investing fund (one "feeder") and the target fund (one "master"). In principle, 100% of the "feeder" is invested into the "master", and only the "master". (Limited "own assets" are possible in the feeder, such as unallocated cash, possibly some feeder-specific hedging instruments). A "master" may, however, have more than one "feeder" investing into it.

  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.

Not to be confused with fund of fund structures

It is worth noting that the aim of the Group has not been to liberalise funds-of-funds. While some forms of commingling, such as entity-pooling, can lead to pseudo fund-of-fund structures, this is not the objective per se. Pooling respond to a different logic. It allows manufacturers to achieve a lower cost-of-manufacturing by allowing them to commingle their products for the purpose of investment management. This does not equate to outsourcing, but rather to internal rationalisation of some manufacturing functions. On the other hand, the objective of fund-of-funds structures is to outsource product infrastructure and investment management (i.e. manufacturing) to other providers (i.e. to other manufacturers).

III.2 Why do we need it?

Fragmentation leads to higher costs

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 both at the production and distribution ends. These unnecessary costs undermine asset managers' competitiveness and pull down investors' net returns.

Pooling optimise resources while keeping product diversity

The previous chapter (facilitating UCITS mergers) explains how important barriers to market consolidation can be removed. However, it must be recognised that a single market context does not equate to a single product platform. Europe's diversity is not on the table. A company with a strong presence in multiple on-shore European fund markets might very easily prefer to have separate product lines in some of these markets. Pooling offers a unique way to optimise resources and lower costs while keeping product diversity. Thus, the Group believes that both pooling and mergers are necessary and complementary options.

Provides for more competitive cost structures

There are strong reasons to promote optimizing solutions such as pooling. Asset management firms are struggling worldwide to achieve more efficient cost structures for 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.

Full benefits only if cross-border pooling

In particular, important economies of scale and specialisation can be achieved in multiple-product environments crossing EU borders where these products are under common investment management. This is because pooling directly addresses the costs of fragmentation accruing to funds and asset managers. These benefits can be broken in three categories[29]: better trading execution (thanks to higher trade lot sizes and fewer settlement accounts), lower front-office costs (thanks to economies of specialisation in asset management) and lower middle and back-office costs (due to fewer and larger settlement transactions, degressive fee schedules reflecting scale advantages). Savings thus achieved will outweigh the costs of setting up and using pooling structures (see the Appendices for more details). In the UCITS space, the benefits of pooling have been limited to date to funds in the same domicile.

Clear benefit for investors

Part of those savings would accrue directly to the end-investors in terms of better trade execution and lower transaction and custody. Savings would also increase the competitiveness of the products of asset managers, particularly in relation to products from large, homogenous and scaled markets outside Europe. Ultimately, these may feed back to the end-investor through the free play of competition.

The Group has analysed the main obstacles to the use of pooling techniques. The table below summarises the current situation.

Virtual pooling	Entity pooling
Custodial regulations The depositary is not always allowed to delegate custodial functions on a cross-border basis. **Clarification** Clarification and common interpretation are missing for issues related to quality of ownership, accounting policies, independence, operational risk, and other.	**Withholding tax** If the pool is not considered fiscally transparent for withholding tax purposes this can have a negative effect on post-tax returns. **Investment regulations** The UCITS Directive diversification requirements do not permit entity pooling.

[29] More details on how pooling has achieve savings at these three levels is provided in annex.

III.3 How can we get there?

a. Investment funds

CESR a role in clarification and education re. virtual pooling

Virtual pooling is the main method used to pool UCITS assets by a large number of investment funds operating under UCITS / UCITS III frameworks in Luxembourg and Dublin. These funds have disclosed the virtual pooling arrangements in their prospectus. They are in many cases approved for distribution in a number of European markets. However, virtual pooling technology can be complex depending on the level of sophistication of the product and the service-provider. This raises a number of concerns on the side of regulators that should be overcome. A concerted effort by CESR[30] 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.

Entity pooling should be allowed

UCITS diversification provisions clearly prevent the industry from making use of entity pooling techniques. However, non-UCITS investment funds operate in many European markets under “entity-pooling” structures in the form of customised products tailored to specific requirements. A targeted, surgical amendment to the Directive specifically to enable UCITS Designated Commingling Structures seems the best way of ensuring that mitigating measures are excluded.

More details on the Experts' proposals are provided below.

The Group's recommendations are the following:

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 UCITS it designates (Designated UCITS Commingling-In Fund, or 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 within “common control” within a single group.

   - The investment limits under Article 24 of UCITS III with respect to diversification should be

[30] The Committee of European Securities Regulators

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 into DUCOFs within the same structure

3. Appropriate disclosure requirements should apply to DCS 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 custodian based in the EU under its responsibility (see depositary section below).

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 ask CESR's advice in order to clarify 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

b. Pension funds

The Group also considered it important to address barriers to pension pooling. 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.

Barriers to pension pooling should be also addressed

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. However, those are not without obstacles, particularly in the case of entity pooling. The table below shows the main hurdles to pension pooling and some solution elements. The Groups' recommendations are presented in the following box.

Virtual pooling	Entity pooling
The Group has not identified any particular obstacle/ concern re. virtual pooling	**Withholding tax** The pool must be considered fiscally transparent for withholding tax purposes. **Accounting and performance** CEIOPS[31] must advise on accounting and performance. **Investment regulations** Mechanism for pension funds to apply CEIOPS diversification rules.

The Group's proposals re. pension pooling are the following:

1. CEIOPS should review Member States' transposition of the Occupational Pensions Directive to confirm that pooling is, indeed, permissible. However, other things being equal, the Group considers that it is.

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, with a view to relating this effort to the possible impact on UCITS and their use by pension funds.

IV. Making the Management Company Passport work

IV.1 What is a management Company Passport?

Ability to passport 'collective portfolio management' services cross-border

Directive 2001/107/EC[32], (the 'Management Company' Directive 'MCD' or 'the Directive') was intended to breathe life into the UCITS Management Company, which, up until that point was a purely domestic vehicle that existed to manage FCP's, Unit Trusts and other 'contractual' funds and those corporate funds which chose not to manage themselves.

[31] The Committee of European Insurance and Occupational Pensions Supervisors

[32] 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

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'[33] ('CPM') services in a similar manner to other financial intermediaries under the principle of mutual recognition.

In addition, the Directive granted UCITS management companies the ability to become authorised to provide, and to passport, some 'bolt-on' services listed in MiFID under operating conditions laid down in that Directive. The provision of these services had previously been the exclusive preserve of MiFID firms and credit institutions.

Also applies to some 'bolt-on' services in MiFID

IV.2 Why do we need it?

The rationale behind the management company passport was that it would enable an investment manager that managed UCITS in multiple jurisdictions to centralise its management company activities within a single jurisdiction. This would result in two advantages:

Duplication limits economies of scale and control synergies

First, it would facilitate a better control environment, since it is easier for an asset management company to control risk when all activities are carried out in a single company, than when those activities are carried out in multiple companies in different countries.

Second, it would enable an asset management company to enjoy economies of scale. The savings potential is real and significant. The establishment and maintenance of a UCITS III management company in an 'exporting' country can cost between € 500,000 and € 1 Million. By centralising management company services in the best resourced management company these costs can be saved. It is not just a question of cost savings: substantial control enhancements may be achieved and supervisors closest to the performance of the management activities will be better able to monitor and intervene.

Cost savings potential up to € 1 million per management company

IV.3 Where do we stand?

One of the driving principles of the 2001 amendments to UCITS Directive was to provide the UCITS management company with a life beyond the borders of their home states by allowing them to passport their activities cross-border. This objective has not been realised. Management companies remain landlocked within their own Member States. We are not aware of any UCITS which is managed by a foreign management company.

Management companies currently locked in their Member States

Despite extensive criticism of this distinction by, amongst others, the Economic and Social Committee of the European Parliament, the text of the finalised Directive excludes the possibility for a 'common fund' (unit trust or contractual fund) to be created or managed by a foreign management company. This limitation immediately excluded a very substantial component of the European industry from any real benefits the Directive could offer. Recommendation 1 set out below calls for removal of this unjustified restriction.

Law prohibits access to contractual funds

[33] See Annex II, Directive 2001/107/EC

A number of national legislators took the language of the Directive at face value when transposing the text. They provided for domestic 'corporate' funds to be managed by foreign management companies. They changed their stance when it became clear that EU-wide mutual recognition would not be forthcoming for their own management companies. It is imperative that those jurisdictions revisit this decision and give immediate effect to the right for their funds to employ a partner country manager. Recommendation 2 set out below calls for correct transposition of the Directive. Recommendation 6 calls for regulatory co-operation.

Regulators prohibit access to corporate funds

Even if a functioning passport were available for some or all types of management companies it is not immediately apparent what passportable activities this would imply in the hands of a management company. Some activities stated to be included in CPM are those held by many Member States as being necessary to be performed in the home state of the fund to evidence that the fund's 'head office' is in the same location as its registered office.

Some Member States insist perform parts of CPM in fund's home State

What constitutes the 'head office' of a fund is something that it is not defined by the Directive. In the tax codes of some Member States the concept of a 'head office' has been taken to mean the 'centre of effective management control'. However, a typical manifestation of this principle today focuses on purely administrative rather than managerial functions. Such 'Central Administration' or 'Minimum Activities'[34] rules impinge substantially on the freedoms supposedly available to management companies. Recommendation 3 calls for a resolution to the conflict between the 'head office' concept and the management company passport.

Need clearer definition of 'head office' so not infringe on passport

All group members agreed that these contradictions must be resolved if the management company passport is to be a viable proposition. Part of the Group members argued in favour of an extensive interpretation of passportable activities. This would give fullest expression to the logic of a single market. Other members thought that this approach risked going too far – and voiding the concept of fund domicile and administration of any meaning.

In addition, there is a lack of clarity around what CPM is intended to be and to what extent component parts of CPM are independently passportable. Recommendation 4 set out below aims at clarifying these concepts.

Need clearer definition of CPM and parts that are independently passportable

The Directive grants to a UCITS management company the ability to seek authorisation to provide some 'bolt-on' investment services listed in MiFID. These freedoms appear, to a large extent, to be available throughout the EU. However, take-up of these possibilities has been extremely low. Based on the limited data available, it would appear that less than 1% of management companies which are now 'UCITS III compliant' have sought to avail of these freedoms. We believe the reasons for this are inertia, lack of a compelling business need, conflict of interest concerns and a mismatch between the services available and what promoters want their management companies to do. We recommend (Recommendation 5) that the MiFID services available to UCITS Management Companies be reassessed based on the identified needs of the industry.

Right to passport non-core services is of limited commercial relevance

[34] IML 91/75, page 13, Chapter D.(Luxembourg) and UCITS Notice 2.2. no. 35 (Ireland)

IV.4 How can we improve the situation?

The Group believes that this fractured landscape is not what was intended when the proposal for the Directive was introduced and that all steps should be taken to give full expression to the management company passport. To this extent, the relevant provisions of the UCITS Directive need to be reworked through the adoption of the following recommendations.

The Group's recommendations for action are:

1) **Remove the discrimination in the Directive between contractual and corporate funds, to allow foreign management companies the right to create and / or manage the former.**

   The (to date) purely theoretical possibility for a UCITS to appoint a foreign management company, or for a management company in one Member State to establish a fund in another, is confined to corporate funds. Legislators seem to have been operating under the misapprehension that a similar scenario was not possible for contractual funds or unit trusts given their lack of legal personality.

   We disagree and recommend that the distinction between fund types (common funds/unit trusts and investment companies) made in Article 1a.5 and elsewhere in the Directive be removed. The deed or contract establishing a unit trust or common fund should specify the UCITS' home Member State by reference to :

   - the domicile of the regulator responsible for its authorisation and/or
   - the domicile of the trustee or depositary

   rather than the location of the registered office of its management company, as is currently the case.

2) **Implement the promised jurisdictional separation of UCITS funds and their management companies.**

   The Directive foresees that a corporate fund and its management company can be domiciled in different jurisdictions. Those member States which have failed to provide for this situation should do so on the basis of the existing Directive – and without waiting for further legislative changes. Furthermore, by removing the distinction between corporate and contractual funds (as recommended above) this freedom should also be extended to contractual funds.

   All supervisors should put in place measures to facilitate mutual recognition of this freedom. The Directive (Article 6) is explicit in describing the necessary framework to support the inter-supervisor co-operation needed to allow the smooth functioning of the management company passport.

3) **Resolve the conflict between the freedoms promised to management companies and the "head office" concept.**

   The Expert Working Group debated removal of the requirement that the 'head office' of the UCITS be situated in the same Member State as its 'registered office'. Implementation of this

requirement can limit the scope of activities which the management company can provide on a remote basis.

The group supported the principle of the management company passport. However, there were two views on the scope of activities which should be covered by the management company passport.

- Part of the group supported a more restrictive interpretation of the range of passportable management company activities. This was judged necessary in order to allow continued supervisory oversight and ability to intervene locally in critical operations of the fund. The view was also expressed that removal of the 'head office' concept thereby permitting, for example, fund valuations to be performed in the management company's home member state would open the door to tax authorities wishing to challenge the tax domicile of the fund.

- Another part of the group was of the view that the 'head office' concept is redundant and needs to be removed if the single market freedoms promised by the Directive are to be realised and identified non-legislative ways of resolving the purported tax issues.

In taking forward work on the management company passport, the Commission is urged to investigate and resolve these issues in a way that is consistent with the rational, efficient and sound organisation of the industry.

4) **Clarify the meaning of a number of concepts related to CPM in the Directive.**

Clarity is required on the exact nature of the 'activities included in' collective portfolio management. They need to be exhaustively enumerated and re-defined using terminology commonly understood in the industry.

A logical and consistent understanding of what component parts of CPM are passportable or otherwise capable of being provided cross-border independent of CPM itself is required. This work could be embodied in EU implementing legislation adopted under Article 53a of the Directive.

5) **Reconsider MiFID activities available to management companies.**

We question the continuing validity of the rationale for the selection of MiFID activities made available to UCITS managers. Given the extremely low take-up of the existing freedoms we recommend that the selection be reassessed based on the needs identified by the industry.

The Group discussed whether MiFID authorised investment firms should be allowed to manage UCITS on the basis of their MiFID authorisation – subject to compliance with the operational provisions of the Management Company Directive and the provisions of the Product Directive. Some group members believed that this amendment would establish symmetrical treatment given that UCITS managers are allowed to undertake non-collective portfolio management services subject to compliance with the operating conditions of MiFID. This would facilitate rationalisation within groups with both MiFID firms and UCITS management companies. Other group members were of the view that authorisation under MiFID was insufficient to ensure the existence of the technical and human resources

necessary to operate a UCITS. The Group recommends that the Commission services explore these concerns further bearing in mind the freedoms at stake.

6) **Enhance co-operation between regulators to facilitate mutual recognition.**

We recommend that supervisors make full use of the co-operation tools already provided by the Directive. These encompass an extensive set of tools to provide for the effective supervision of funds administered in one Member State but being managed from another. These possibilities include the requirement for the management company's home member state to facilitate the service of legal proceedings on its authorised management companies by the fund's home state regulator.

'Dual' supervision has long been a reality for other European Financial Services. There is no fundamental reason why these principles and structures cannot be made to work in support of the UCITS management company passport.

V. More freedoms for the Depositary

V.1 The role of the Depositary

The depositary function was enshrined in the original UCITS Directive, dating back to 1985. This text involved the creation of a special function to oversee the activities of the fund manager and protect unitholders against the improper sequestration of assets. The Directive entrusted the depositary with two distinct missions:

1) safekeeping of the assets of the UCITS,
2) an oversight function that involves controlling the assets (for both mission of safekeeping and trustee monitoring).

In some Member States, depositaries have been charged with additional responsibilities of a fiduciary nature[35].

No common definition of depositary's role and responsibilities

The EU legal framework governing the activities of the depositary has been left untouched since 1985. The Directive does not require that the depositary be a separate legal entity from the fund manager – only that it should be functionally separate. The Directive requires that the depositary be domiciled in the same country as the management company (and by extension of the fund). This reflects the view that there is a need for close proximity between the depositary and fund to allow the depositary to perform effective real-time monitoring in respect of the activities of the fund.

Depositary has a key role re. investor confidence

The depositary function plays an important role in sustaining a high level of investor confidence. It has been particularly important in winning investor acceptance for products domiciled in other Member States by building in a common

[35] 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.

structural safeguard against fraud or operational error. Given the increased complexity and heterogeneity of funds, the role of the depositary becomes even more important control on the way in which the fund manager conducts its business.

V.2 Where do we stand?

The safekeeping (often known as "custody function") is already very similar across EU Member States. The principal area of divergence relates to the absence of a harmonised definition of asset safekeeping definition – particularly regarding the extent of obligations to return assets.

Custody function practically harmonised; control function differs widely.

Conversely, the "control/trustee function" differs widely across Member States, each national regulator imposing different type of controls. In the absence of a precise EU-level definition, the depositary has been assigned different roles and responsibilities at national level. Those differences are widening as a result of new national legislative initiatives triggered by the development of the fund industry and the increasing complexity of products.

A long-running debate in the fund industry is whether fund managers should be forced to rely on the services of depositaries located in the same jurisdiction. The Commission Green Paper of 2005 asks whether depositaries should be free to provide services to funds in other Member States – which roughly translates into a European depositary passport. The intuition behind this proposal probably reflects the fact that all Member States recognise that depositary functions are carried out, inter alia, by financial institutions which are authorised and supervised in accordance with EU financial services legislation and otherwise capable of operating cross-border.

A shared understanding of the role of the depositary – based on deeper harmonisation is first needed to sustain investor confidence in UCITS. Harmonising the role and responsibilities of depositaries will contribute to the stability and strength of the UCITS label. Harmonisation – and ultimately a depositary passport - will also support the facilitate development of the fund industry on a pan-European basis since it will:

… but harmonisation of some elements will support the development of the industry, facilitate cross-border business, risk mitigation and reduce costs.

- facilitate cross-border fund distribution;
- increase investor acceptance of UCITS across the EU and globally;
- improve risk mitigation
- contribute to confidence between regulators: regulators rely significantly on the depositary function to ensure investor protection. Some harmonisation of the rule and functions of the depositary will contribute to build trust among regulators which will facilitate cross border business;
- reduce costs as the ability to implement a common business model on a European scale will enable the depositaries to maximise economies of scale and minimise operational costs.

As a precondition to a depositary passport, the Group believes that further work is needed to determine the features of the regulatory landscape which need to be harmonised and the conditions under which this can be best achieved. The

There are many obstacles in the way to

Commission Communication[36] on the "regulation of UCITS depositaries in the Member States" provides a largely up-to-date inventory of the principal features of depositary activity which would warrant harmonisation. Business practices have revealed some additional issues.

harmonisation…

The following include some of the principal areas of divergence that would need to be tackled.

… that need to be tackled.

- Member States allow different types of entities to perform depositary services, including but not limited to investment firms, credit institutions and insurance companies. This means that depositaries are subject to very different prudential rules – particularly regarding capital requirements with minimum capital requirements varying from € 5 million to € 100 million. Harmonisation of the **capital requirements**, as a first step on the road to the depositary statute harmonisation, is necessary to create a level playing field.

Different capital requirements creates an unlevelled playing field

- **Definitions terms and responsibilities** pertaining to the depositary function should be harmonised.

  - Legal uncertainty can result from the commingling of depositary-specific legal obligations and broad civil case law. This is especially true 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. Only three Member States seem to exclude "force majeure" as an extreme waiver of responsibility. Under such conditions, retail investors actually bear a risk (and costs) which are a priori hidden to them.

Different approaches lead to legal uncertainty

  - The absence of a common understanding of 'asset safekeeping' is an important drawback. 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: is it only in charge of prudential controls over possible external custodians or is it a full-fledged "keeper" bound by obligations towards the manager and the investors, independently from its controls? 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 partly achieved for classical types of assets such as equities and bonds but not for other asset classes which will become an increasing part of UCITS assets. The underlying obligations will also need to be studied, in order to determine if harmonization would allow the custodians to rationalize their custody platform across the EU including the type of reporting required and to ensure a level playing field between custodians.

Definition of depositary functions not harmonised

  - Depending on the Member State, 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.

[36] COM (2004) 207 final, 30 March 2004

Harmonisation of these regulatory features remains a **long-term** goal. It will require a thorough reworking of existing Directive provisions. Some initial steps could be taken quickly on the basis of existing UCITS provisions, which would provide some improvements in the competitive sourcing of custodian and depositary services. These incremental improvements would already constitute a significant step towards realising tangible benefits at this step of the value chain.

In the short term, Member States should make use of the discretion available to broaden the range of entities who are allowed to provide depositary services. A case in point concerns the recognition of the right of branches of EU banks to act as a depositary. For example, the UCITS Directive remains silent regarding the statute of branches of EU banks that can act in another EU country. Certain Member States do not allow bank branches to be registered as a depositary.

A second 'quick win' would be for Member States to allow the depositary to delegate safe-keeping to a custodian located in another EU country. The delegate custodian should nevertheless contractually agree to comply with the depositary's local regulations, with regards to asset safe-keeping and restitution. This would insure protection even if assets are held in another EU jurisdiction and a level playing filed for custodians. At present, certain Member States (such as Luxembourg) implement restrictive practices in this regard. The group encourages all jurisdictions to implement enlightened practices, and drawing comfort from the experience of regulators and supervisors that currently implement such an approach.

V.3 How can we improve the situation?

Two-step approach

In light of the above, the Group recommends following a two-stage approach:
1) in the short-term, on more easily achievable but effective measures,
2) in the longer-term, analyse the main legal barriers in order to have a further harmonisation of the role and responsibilities of the depositary. The proposed measures are summarised below.

In the short-term, the Group recommends that:

i) Member States allow branches of EU established banks to act as depositary for locally domiciled funds

ii) Member States allow the Depositary to delegate custodial functions to licensed custodians located elsewhere in the EU: This would allow important scale effects resulting in lower units costs for safekeeping/custody functions. To allow implementation of this proposal while maintaining the existing level of investor protection, the delegated custodian should contractually agree to comply with the depositary's local regulations, with regards to asset safe-keeping and restitution.

In the long-term, the Group recommends that the Commission undertakes:

i) A harmonisation of the capital requirements for depositaries: Depositaries do not have the same status across the different Member States. Some or all of the following - investment firms,

credit institutions, insurance companies, other firms - may qualify for authorisation as depositary in different Member States. A harmonisation of the capital requirements, and more broadly of the status of the depositary, is necessary in order to support the sound management of risks and continued investor confidence.

ii) An investigation to remove legal barriers: Further study is needed regarding the impact of differences between depositary obligations which are couched as "obligations as to result", or as 'obligation of (prudential) means'. To realize scale economies on the custody side, the definition of asset safekeeping for all types of assets need to be studied across the EU. Differences in liabilities regarding the safekeeping of assets (e.g.: restitution obligation in France, an obligation that does not exist or is more limited in other member countries) should be removed.

VI. Conclusion

Inflexible legislative framework hinders the development of the fund market

The demand for investment products is rapidly evolving and competition for investor savings is strong. However, the EU fund industry is not correctly equipped to respond to these challenges.

Although the UCITS framework has been critical in the fund industry's development, its unnecessarily onerous requirements and inadequate organisational flexibility are holding the industry back. The consequences of these inefficiencies are reduced investor choice, untapped economies of scale, unexploited specialisation benefits and higher costs.

Need for urgent action on:
1) authorisation/ notification
2) fund mergers
3) pooling
4) management co. passport
5) depositary flexibility

A long debate on possible solutions has taken place during the past several years. It is now time to act: authorisation and notification times must be reduced, fund mergers must be facilitated, pooling possibilities must be exploited, the management company passport must be improved and the depository must have more flexibility.

Interest of investors taken into account

The Expert Group does not consider this agenda to be an optional list of measures; rather, it is the minimum set of actions that must be implemented in a prompt and focused manner. The necessary conditions to successfully put these proposals into practice are detailed in this report. Recommendations seek to protect investors and ensure that they will benefit from efficiency gains.

Implementation in Member States within three years

Legislative change is required to provide a sound basis for the new mechanisms, and the Group encourages all stakeholders to constructively engage in the proposals. These measures must be implemented in Member States in the next three years, as the fund industry has already fallen behind. In order to achieve this timescale, this Group recommends that the relevant parts of the UCITS Directive are amended. To retain flexibility for further development, these amended articles should be in a Lamfalussy style, with level 2 powers given to the Commission

In the longer-term consider Lamfalussy approach

In the future, a shorter legislative cycle will be necessary to keep pace with markets. Making the whole UCITS Directive Lamfalussy compliant should therefore be considered as a second step, once the above recommendations are in place.

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