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accompanying the

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

IMPACT ASSESSMENT OF THE LEGISLATIVE PROPOSAL AMENDING THE UCITS DIRECTIVE

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EXECUTIVE SUMMARY

This report summarises the steps that has led to the preparation of the Commission draft legislative proposal on amendments to the UCITS Directive. This legislative proposal is the result of a long process of analysis and open consultation that started in 2004 with the publication of the recommendations of the Expert Group on Asset Management. This Expert Group identified a clear need to improve the efficiency of the European market for investment funds and recommended measures in a number of priority areas. Subsequent research and consultations have confirmed this need for EU level action and have helped to design the possible solutions.

These solutions have been tested at two stages. A first impact assessment was carried out in 2006 in preparation of the White Paper on enhancing the single market framework for investment funds. That first impact assessment singled out the areas requiring changes to the UCITS Directive. This second impact assessment report focuses on how those changes could be implemented in order to maximise their cost-effectiveness while preserving high levels of investor protection. The analysis in these two impact assessment reports is based on extensive discussion and consultation with all interested parties, relevant market data, a thorough review of the existing related literature and the outputs produced by ad hoc workshops and externally conducted studies. The choices retained in the legislative proposal are in line with the conclusions of these two impact assessment analyses. The proposals try to strike a balance between stakeholders' efficiency expectations and investor protection concerns.

This report analyses two types of legislative changes: those aiming to enhance the working of existing provisions (namely in relation to the notification procedure, the management company passport and the simplified prospectus); and those aiming to introduce new single market freedoms (by creating a facilitating framework for fund mergers and asset pooling). The guiding principles of this analysis have been market efficiency and investor protection. Particular attention has been given to the need for reducing administrative burdens. The recommended decisive simplification of the notification procedure and of the simplified prospectus would lead to a significant reduction of those burdens. Recommendations in relation to the other legislative change areas also pursue simplification by clearly identifying the respective responsibilities of the industry and competent authorities.

The economic savings to be expected from the proposed measures take the form of both static costs savings for industry and investors and dynamic benefits linked to increased competition and productivity gains. Direct benefits range from the identified savings of the new notification procedure (most of the current € 20 million initial notification costs and probably also the € 25 million annual costs of maintaining notification) to the several euro billion to be saved annually if European funds could fully exploit the economies of scale derived from consolidated management through fund mergers or asset pooling. The simplification of investors' disclosures, the possibility to use electronic transmission means and the recommended language regime will also entail important savings. Important dynamic effects are also to be expected. Greater flexibility to organise and conduct the fund business and simplified procedures should create new business opportunities and increase the fund industry's competitiveness vis-à-vis that of other products and markets. A more integrated investment fund market will also offer the European investor an enlarged choice of better performing funds. Preserving the high levels of investor protection already offered by UCITS funds will reinforce their attractiveness within and beyond EU borders. Over the long run, these positive effects will contribute to the enhanced economic efficiency and competitiveness and thus give effect to the Lisbon strategy goals in this important sector.

1. INTRODUCTION

This report describes the process and elements that have led to the preparation of the legislative proposal amending the UCITS Directive[1]. An important milestone in this process was the White Paper on enhancing the single market framework for investment funds[2] (November 2006). The White Paper announced, among other measures, targeted amendments to the UCITS Directive. The White Paper based its conclusions on the impact assessment (IA) work carried out ahead of its adoption. That IA[3] identified the problems hindering the effective working of the European fund market and analysed the different options to overcome them.

This report aims to avoid any unnecessary duplication of the work already undertaken. For example the need for EU action has already been demonstrated by the White Paper Impact Assessment (WPIA) analysis. That IA concluded that an amendment of the Directive was the most cost-effective option in relation to the issues analysed in this document. The report will therefore concentrate on the concrete legislative changes and, in particular, on the different possibilities available for designing these. It should be also noted that this report is to serve as a basis for comment and does not prejudge the final form of the legislative proposal. This initiative is part of the Commission's simplification rolling programme under the "Community strategy for simplifying the regulatory environment" (COM (2005) 535).

The White Paper and the WPIA can be found at:

http://ec.europa.eu/internal_market/investment/legal_texts/index_en.htm#whitepaper

1.1. Content

Section 2 aims to facilitate the reader's understanding of the issues discussed in this report by providing an overview of the European investment fund market and of the review of its framework. Section 3 will briefly recall the analysis and conclusions of the WPIA. Section 4 focuses on the design of the legislative measures announced in the WP. Section 5 presents the monitoring strategy following the adoption of the legislative proposal. Fiches developing in greater detail the topics analysed in this report are included in annex 7.

1.2. Procedural issues and consultation of interested parties

The five-year Financial Services Action Plan (FSAP) launched in 1999 concentrated strongly on the completion of the single market for wholesale services. Towards the end of the FSAP period, it was clear that other areas would need close attention after 2004. In preparation of the strategy for the post-FSAP, the Commission established four groups of experts of which one focused on improvements to be done in the area of asset management (investment funds). The recommendations contained in the experts' report were the starting point of an extensive

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[1] Undertakings for Collective Investment in Transferable Securities Directive 85/611/EEC of 20 December 1985 amended, inter alia, by Directives 2001/107/EC ("Management company Directive") of 21 January 2002 and 2001/108/EC ("Product Directive") of 21 January 2002 (UCITS III directives).

[2] COM (2006) 686 final, 15th November 2006.

[3] Impact Assessment accompanying the White Paper on enhancing the single market framework for investment funds {COM(2006) 686 final}

process of reflection on ways to improve the functioning of the European market for investment funds.

The conclusions presented in this report are the result of intensive analytical work developed on the basis of a variety of inputs. These ranged from bilateral informal meetings with stakeholders to studies, expert groups, open hearings, public consultations and workshops. Many of these events brought together different stakeholders. The objective was to better assess the implications of possible actions on each side of the market. Most of these exercises have been open and are largely documented on the Commission's website. The openness and transparency of the process has been highlighted and acknowledged frequently by stakeholders. The main elements of this process are described in annex 1.

1.3. Changes following Impact Assessment Board evaluation

This report was submitted to the Impact Assessment Board (IAB) on September 26th. The IAB main recommendations related to the structure and presentation of the report. It also recommended to improve the analysis of economic impacts, in particular how those will benefit investors, and to better assess the reduction in administrative burden. A more quantitative assessment of impacts (including the administrative burden) has proved difficult due to the lack of data. However, additional quantitative examples have been included and the qualitative elements of the analysis strengthened. A concluding section has also been introduced in order to better describe the global effect of the package of measures, as well as the synergies and trade-offs between the measures proposed. IAB suggestions to clarify certain aspects of the analysis have also been followed.

2. THE EUROPEAN MARKET FOR INVESTMENT FUNDS

2.1. Background

What are investment funds?

Investment funds are specially constituted investment vehicles, created with the sole purpose of gathering assets from investors, and investing those assets in a diversified portfolio of financial instruments. Investors buy units issued by the fund against the portfolio of underlying assets, and the value of those units fluctuates with the value of the portfolio. In this way, small investors can buy exposure to a professionally managed and diversified basket of financial instruments. Overheads and other costs are spread over the pool of investors, reducing average cost for the investor.

Investment funds: main actors

Management Company: Responsible for the day-to-day management of the fund. This usually involves the management of the assets but also a number of associated administrative functions such as record keeping, regulatory compliance monitoring...

Depositary: Typically carries out two functions: the safe-keeping of the assets and the oversight of the operation of the fund. It has therefore a crucial role in the protection of investors' interests.

National regulator: National authority responsible for the authorisation and on-going supervision of the fund/management company.

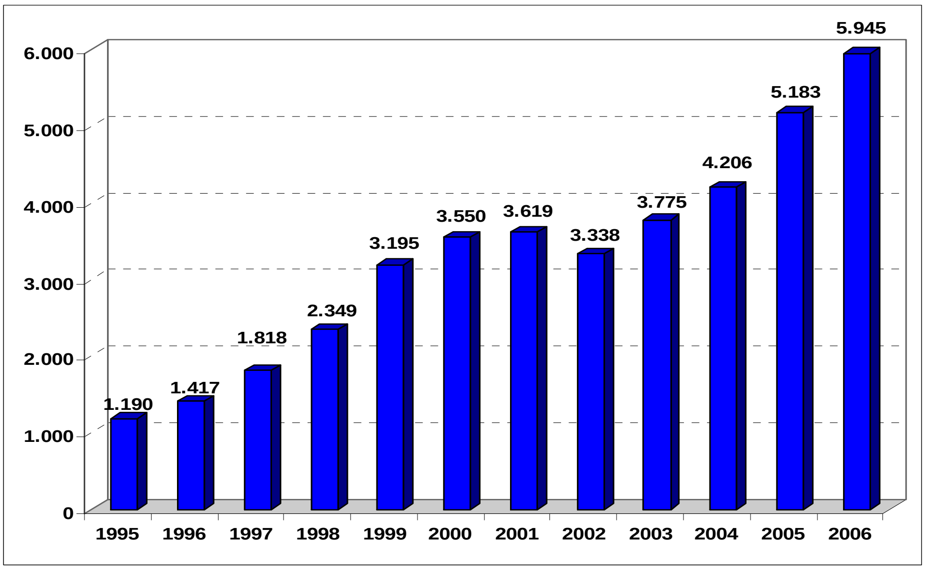
In the 1980s, the European industry for investment funds had started to develop. However, the existence of a patchwork of national legislation had created an increasingly fragmented market. The UCITS Directive was adopted in order to overcome this situation. It aimed to offer greater business and investment opportunities for both industry and investors in an enlarged market. In contrast with more modern pieces of EU legislation, the UCITS Directive regulated the product. It set a series of requirements with which investment funds needed to comply[4]. Their main objective was to ensure high levels of investor protection. It also introduced the first financial services passport. Once a UCITS fund had been authorised by the competent authorities of its country of domicile, it could be marketed all over the EU. It simply needed to notify this intention to the competent authorities of the host market.

Importance of investment funds for investors

Saving in investment funds is one of the many options for households to allocate their assets. Although banking deposits and insurance reserves dominate household savings in most European countries, funds play an important role today. Their average share in EU household assets amounts to 11.5%, varying from 4.1% in the United Kingdom to 26.1% in Sweden[5]. This share should increase in the future. European societies are ageing and there is a growing need for private retirement products. Effective private solutions will be important to complement state and occupational pensions. Investment funds provide an established vehicle for accumulating capital throughout working life.

The UCITS Directive has been key for the development of the European fund market. As of today, assets under management (AuM) amount to nearly € 6tr. and represent about 75% of the EU investment fund market.

Figure 1: UCITS assets under management (€ bn)



4 The Directive for example indicates the list of assets in which UCITS funds can invest and in which proportion.

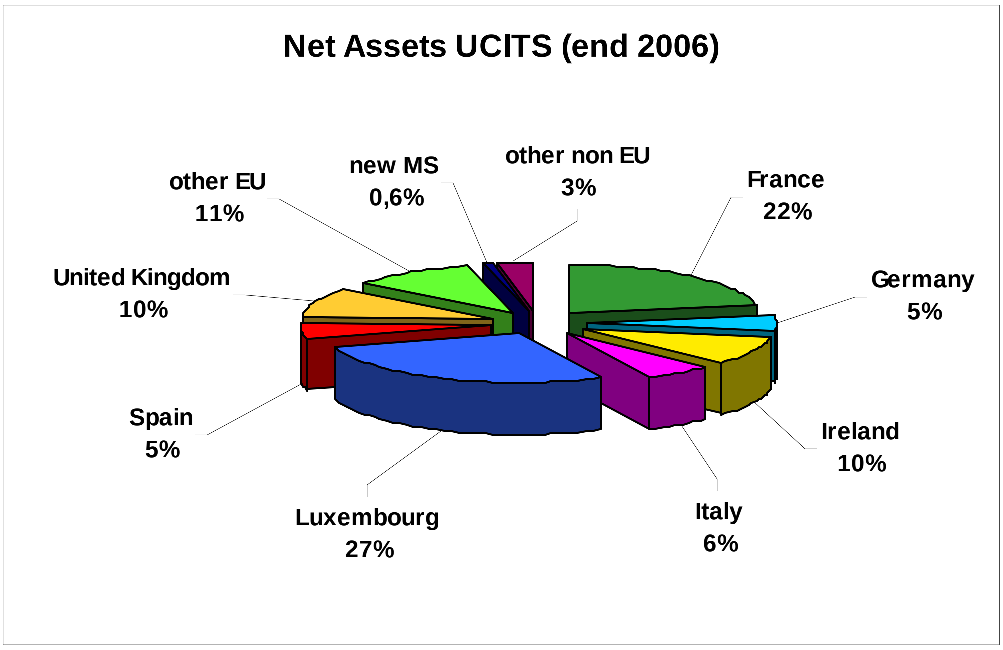
5 EFAMA Fact Book 2007

Source: European Fund and Asset Management Association (EFAMA)[6]

UCITS have grown successfully both within the EU and beyond its borders. Its strong investor protection safeguards have gained the acceptance of financial services regulators in third countries in Asia and Latin America. According to recent market research, Asia represented 15% of European funds' net sales in 2006[7].

Market integration has grown gradually. However, as of today, a mere 20% of the European funds can be considered as 'true cross-border funds'[8]. Nevertheless, they are the faster growing funds[9]. The industry is also characterised by a certain concentration of the activity. The fund management is typically performed in financial centres such as London, Paris and Frankfurt; fund administration in Luxembourg and Ireland (please see in figure 2 UCITS assets per country). Growth of the Luxembourg and Dublin centres is encouraged by the success of cross-border funds and by the migration of some management groups to single-hub strategies[10]. Luxembourg and Ireland funds accounted for 89% of the total European fund subscription in 2006[11].

Figure 2: Geographical distribution (in terms of assets under management)



Source: EFAMA Fact Book 2007

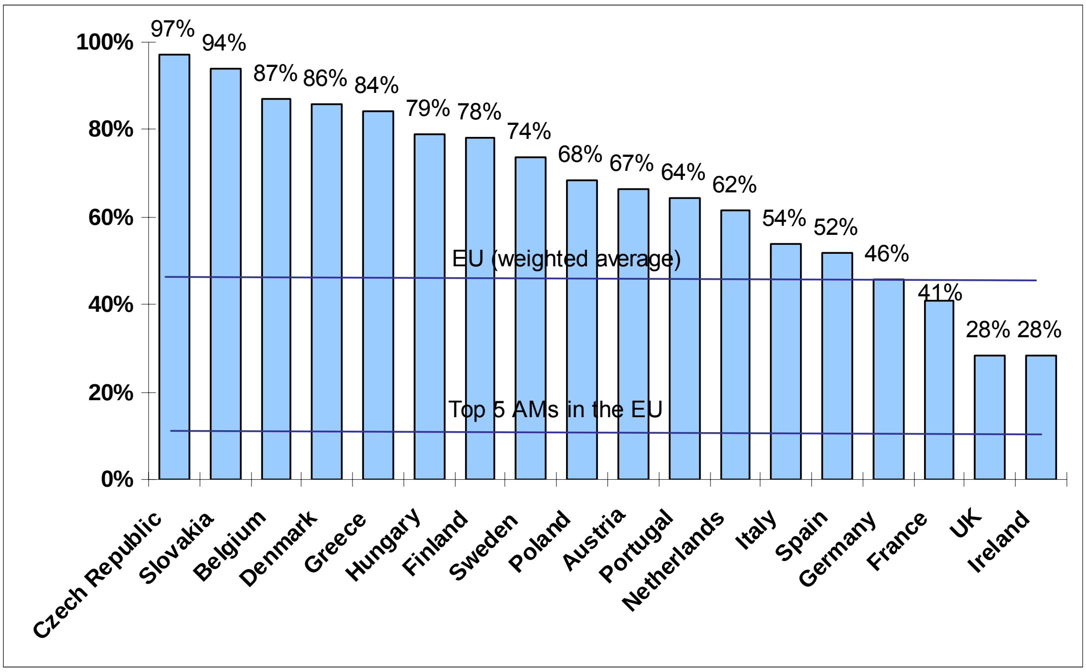
A certain level of activity concentration (measured by assets under management) is also to be found in some national markets. Concentration of asset management companies tends to be

6 Data includes some non-EU countries such as Liechtenstein, Norway, Switzerland and Turkey. Their part in the total assets was 3.2% at the end of 2006.
7 "Windows into Global Asset Management", Strategic Insight, March 2007.
8 Funds that are notified for sale in at least two countries other than their fund domicile (PWC-Lipper data)
9 In 2006, net sales of Luxembourg and Irish funds accounted for 74% of the total UCITS sales. (EFAMA Fact Book 2007).
10 FERI Data Digest 2007.
11 Idem.

lower in the biggest fund markets and higher in smaller markets. In 2004 the market share of top five asset managers was below 30% in Ireland and the UK, while in smaller Member States, such as Greece, Belgium or Czech Republic, it accounted for more than 80%.

The assets-weighted average market share of five largest asset managers in the EU amounted to about 50%. The number of relatively small national markets in Europe partly explains why the average concentration ratio is higher as compared to the US (ca. 40%).

Figure 3: Market Share of Top 5 Asset Management Companies (2004)



Source: ZEW/OEE database, data from EFAMA, Feri FMI, ZEW calculations

At the distribution level, the move towards open architecture[12] is slow, particularly in closed markets dominated by local banks. However, there is an unmistakable trend towards more openness. In 2004 third-party distribution accounted for only 15% of all distribution channels in Europe (compared to 81% share of captive distribution). In 2006, major distributors evaluated that 55% of their activity was third-party[13].

2.2. Reviewing the UCITS framework

Despite this positive evolution, at the turn of the 21st century, it started to become evident that the rigidity of the Directive did not allow UCITS to fully exploit all of the development opportunities. Amendments made in 2001 aimed at modernising the Directive[14]. UCITS investment powers were enlarged and a passport for the management company was introduced. Provisions offering greater business opportunities for the European fund industry were coupled with reinforced investor protection provisions (e.g. minimum capital for the management company and risk management controls requirements). The Simplified

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12 The fact for a distributor of offering third-party funds instead or in addition to its 'in house' fund range.
13 FERI.
14 Please see footnote 4.

Prospectus was created in order to assist investors in taking an informed decision when assessing the suitability of the fund offered to them.

However, the 2001 amendments did not respond to the supply side bottlenecks and barriers that hampered industry efficiency. Some of the 2001 novelties (notably the management company passport and the simplified prospectus) had either failed to produce any positive effect or been implemented in such a way that they had ended up being an additional source of unnecessary costs for the fund industry. A series of deeply rooted inefficiencies were therefore hindering the working of the European investment fund market. These severely handicap the fund industry and prevent it from successfully facing its main challenges. The box below summarises these challenges.

UCITS main challenges

The scope of the UCITS framework. UCITS was designed as a retail product. However, over the years a growing range of non-UCITS funds have developed. These cannot comply with the prescriptive investment rules of the Directive but many are available to retail investors at national level. Extending the UCITS framework to cover these funds would broaden cross-border opportunities for the fund industry and enrich the fund offer to investors.

Competition from other forms of financial product. UCITS compete with other similar investment products – such as (unit-linked) life insurance or structured notes and certificates – for investors' savings. (In 2006, for example, net sales of UCITS fell 5% while those of structured products and unit-linked insurance products increased by 18.5 % and 50% respectively.) It is often argued that their more restrictive regulation handicaps UCITS' competitiveness. There exists therefore the risk that investors will be directed to cheaper forms of investment but which often offer lower levels of investor protection.

Global competition. UCITS authorisation has won wide global recognition as a guarantee of sound product and effective regulation. However, competition from other fund jurisdictions is starting to build. To continue to attract custom from around the world, it will be necessary to eliminate unnecessary cost and to support innovation.

Financial innovation. The Directive's strict product design means that UCITS investment powers need to be continually revisited in order to keep pace with financial innovation. It has often been argued that a risk-based (instead of a product) approach could overcome that problem.

In 2004, the recommendations of the expert group on asset management (AM)[15] were the first important contribution to the review of the working of the UCITS framework that has led to the legislative proposal. This review process is summarised in figure 2.

The expert group's report identified a list of issues requiring action. Responses to the open consultation that followed showed that there was a widespread consensus that there was considerable room for improvement in the area of investment funds.

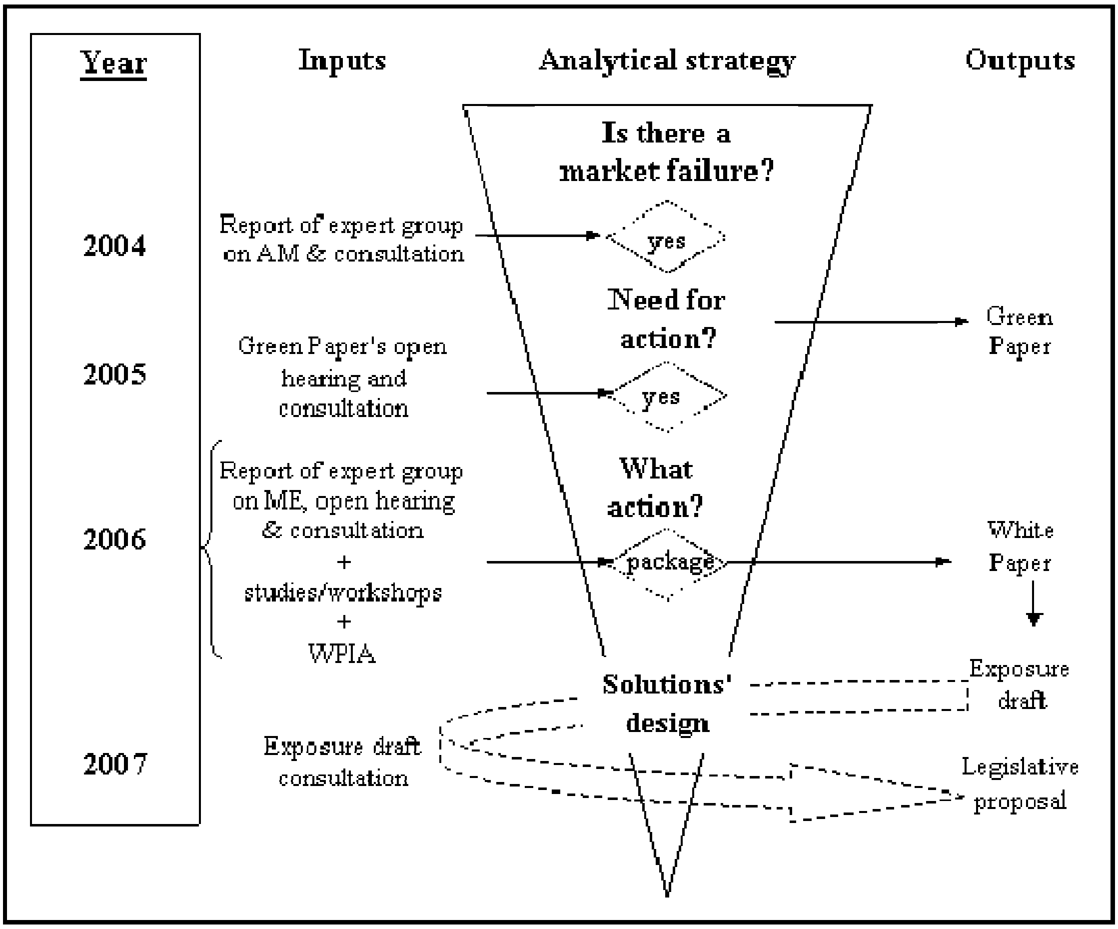
One year later, the Commission Green Paper on investment funds[16] launched a public debate on the need for EU level action (and its scope). First of all, a strategic choice needed to be

[15] "Financial Services Action Plan: Progress and prospects", Asset Management Expert Group Report, May 2004.

made: could targeted measures respond to stakeholders' expectations or was a more wholesale reform of the investment funds legislative framework needed?

Both Commission services research and stakeholders consultation led to the same conclusion[17]: focus should be on modifying the Directive to remove remaining barriers to market access and to allow fund industry to organise fund management and administration more efficiently within the single market[18].

Figure 4: The UCITS framework review process



Once the strategy had been chosen, it remained to determine those areas actually requiring EU level action. This was done in the WPIA. The problem areas identified then are listed in the box below[19]. To effectively address these problems the WPIA analysed a series of options and assessed them against their impact on a) fund industry's efficiency, b) investor protection and c) market integration.

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16 Green Paper on enhancing the European framework for investment funds, COM(2005) 314 final, 12th July 2005.

17 Please see the 'Consultations' part in annex 1.

18 A complete overhaul of the Directive would have required a more extensive rethinking of the design of the UCITS framework and, at that stage, the advantages of that option did not seem compelling enough.

19 Please refer to section 3.1 or the IA fiches of the WPIA for a more detailed description.

Investment fund market: problems identified

<u>On the supply side:</u>

▪ Proliferation of funds of a <u>sub-optimal size</u>: This impedes the exploitation of economies of scale and increases costs. As a result the Total Expenses Ratio of a typical cross-border European fund is much higher than that of an American fund.

▪ <u>Lack of flexibility</u> in organising the industry value-chain: The UCITS Directive restricts the ability of the fund manager/fund as to the location of key core functions. The UCITS Directive requires that the depositary is based in the same country as the fund. Also the possibility for the management company to offer its services across borders is restricted in practice. This not only limits the capacity of the industry to achieve economies of scale and specialisation, but also leads to a duplication of resources that raises costs.

▪ <u>Barriers in getting funds into the market</u>: UCITS Authorisation (by the Home Member State) and Notification (to the Host Member State) procedures are often long and cumbersome. While the direct costs are limited, uncertainty as regards the duration of the procedure can have an important impact on business opportunities. Both uncertainty and long delays seriously handicap the fund industry in competing with other investment products (e.g. unit-linked insurance contracts, certificates…)

▪ <u>Strict investment restrictions</u>: The definition of the product imposed by the Directive is perceived as limiting the investment and business opportunities for both investors and industry offered by the financial innovation. The problem is compounded by the fact that UCITS compete with other products with similar characteristics but subject to different forms of disclosure and intermediary regulation. There is the risk that investment propositions would be repackaged in more convenient regulatory forms offering lower levels of investor protection.

▪ <u>Non-standardised fund order processing</u>: The treatment of a subscription or redemption order implies a series of interactions between different actors and varied (often manual) steps. The lack of automation and standardisation increases costs and delays and can exacerbate operational risks.

<u>On the demand side:</u>

▪ An <u>ineffective simplified prospectus</u>. This is too long and complex and, thus of limited value to the investors. It also entails considerable cost overhead for the fund industry.

▪ <u>High costs and low transparency at the distributor's end</u>. Limited competition and openness have led to sizeable distribution costs. These can amount to up to 75% of total costs in some Member States. Distribution networks are gradually becoming more complex and the number of intermediaries is increasing. This may exacerbate concerns about the loss of transparency and higher costs.

▪ <u>Development of non-harmonised investment funds</u>: National regulatory regimes have been introduced over recent years in order to provide a framework for the development of non-harmonised funds. Unfortunately, divergent approaches and priorities have given rise to a patchwork of incoherent legislation. For the industry, this translates into an important hurdle to the expansion across borders of their business.

In some instances, the WPIA report concluded that EU level action did not appear to be sufficiently justified. Industry-led or national-level initiatives were preferred. In other cases, however, a common approach appeared necessary to overcome the above described hurdles. This was clearly the case of problems derived from inconsistencies or deficiencies of the UCITS Directive. The analysis therefore recommended amendments to the Directive in a number of areas. To address other problems, EU level tools already existed or more research work was needed; non-legislative monitoring measures were then considered to be the most cost-effective option. Accordingly the White Paper announced a series of measures. These are summarised in the table below.

Table 1: Measures proposed in the White Paper

Problem	Changes to the UCITS Directive	If no, which other measure?
Proliferation of funds of a sub-optimal size	**YES**	-
Lack of flexibility in organising the industry value-chain: the management company	**YES** *(if cost-effective solution can be found)*	-
Lack of flexibility in organising the industry value-chain: the depositary	NO	-
Barriers in getting funds into the own market: UCITS authorisation	NO	**(Member States encouraged to expedite authorisations)**
Barriers in getting funds into other MS markets: UCITS notification	**YES**	-
Strict investment restrictions	NO	**Implementing legislation on eligible assets**
Non-standardised fund order processing	NO	**(industry-led initiatives)**
An ineffective simplified prospectus	**YES**	-
High level of costs at the distributor's end	NO	**Monitoring of MiFID[20] implementation**
Development of non-harmonised investment funds	NO	**report, expert group, private placement regime**

On 22nd March 2007, DG Markt published "Initial orientations of possible adjustments to the UCITS Directive". This document, also called 'exposure draft' below, served as a basis for public consultation on the form of those legislative changes. The purpose of the consultation was to gather feedback on how to design the measures announced by the White Paper in a way that effectively responded to stakeholders' expectations and concerns. An overview of

[20] Markets in Financial Instruments Directive (2004/39/EC).

this exposure draft is annexed to this report. Details of the responses to the exposure draft consultation for each of the legislative measures are provided in the relevant IA fiches (annex 7). Respondents' contributions have been an important and valuable input to the analysis developed in this report and to the refinement of the proposed provisions.

3. THE WHITE PAPER IMPACT ASSESSMENT

As explained above, the WPIA report analysed the main obstacles hindering the development of the European fund market and put forward a list of preferred solutions in order to overcome them. As shown in table 1, some of those proposed solutions can be implemented without any change to the UCITS legislative framework. Work in those areas is evolving along the lines described in the White Paper[21] but will not be discussed in this report. Many of the announced outputs will materialise over the next year. Other solutions, however, require amendments to the UCITS Directive. The objective of this section is to recall the WPIA analysis in relation to these legislative solutions. A more detailed description of the problems can be found in annex 7 (and in the relevant annex of the WPIA).

3.1. Problem description

Problem 1: Barriers to marketing funds in other Member States' (MS) markets. The notification procedure (vis-à-vis the host MS authority) introduced by the 1985 Directive is often long and cumbersome. The host regulator's role often exceeds that defined in the Directive (i.e. verification of the UCITS marketing arrangements in the host market) and the two-month limit is not always respected. The procedure has been compared to a second authorisation of the fund by the host regulator instead of a simple communication of the UCITS intention to market its units in the host market (as provided for in the Directive). Estimated direct annual costs for the fund industry for maintaining notification amount to €25 million (in addition to more than €20 million for the initial notification)[22]. While these costs are relatively limited[23], uncertainty as regards the duration of the procedure can have an important impact on business opportunities. Additionally, both uncertainty and long delays seriously handicap the fund industry vis-à-vis other investment products (e.g. unit-linked insurance contracts, certificates…) in attracting investors savings. Foreign funds' difficulties to enter domestic markets restrict competition forces. As a result, investors not only could have access to a broader fund offer but also bear unnecessarily high fees.

Accordingly, the WPIA recommended that amendments to the Directive should a) reduce notification delays, b) replace the current procedure by a regulator-to-regulator communication exchange and c) clarify each MS' authority role and responsibilities.

Problem 2: Proliferation of funds of a sub-optimal size. The European fund market landscape is characterised by a high number of small funds. At the end of 2006, 54 % of European funds managed less than € 50 million in assets[24]. The average European fund is more than five times smaller than its American counterpart. This size difference has persisted over the years. The

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[21] Please see the White Paper's annex 1 for a condensed view of the expected outputs and deadlines of those 'non-legislative' work-streams.

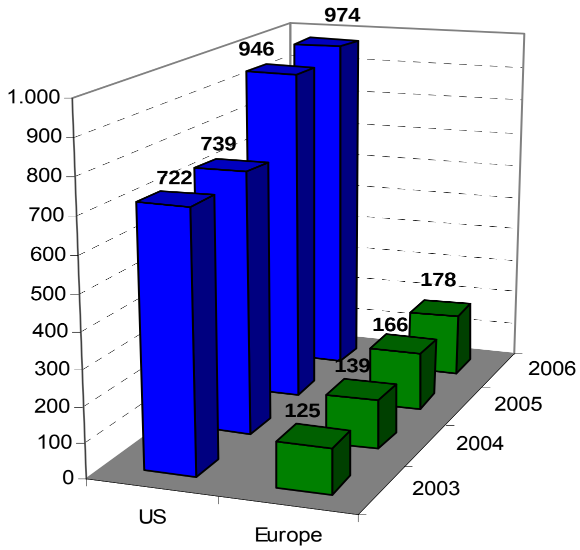
[22] "A Harmonised, Simplified Approach to UCITS Registration", EFAMA and IMA, April 2005.

[23] They account for less than 0.25 basis points (i.e. 0.0025%) of the total fund costs for the largest fund providers. Please see European Commission (2006e) for more details on these costs.

[24] And as many as 20% of European funds have a size below €10 million (FERI, Data digest 2007)

graph below shows the evolution of European and American fund sizes for the four last years. Although some catch up has taken place during that period, this has been quite slow[25].

Figure 5: Average investment fund size in Europe and US



Source: EFAMA and ICI. (End of the year €/$ ECB rates)

Managing large ranges of small funds is costly. It impedes the exploitation of economies of scale and increases costs[26]. As a result, the Total Expenses Ratio of a typical cross-border European equity fund is twice that of an American fund[27]. Annual savings of up to € 6bn have been identified[28]. Current market trends risk exacerbating the problem. Fund launches remain the preferred strategy for asset managers to innovate, raise new assets and respond to new investors' needs or preferences. In 2006, the total number of funds increased by 1,542 (compared to an increase of 887 funds in 2005). According to FERI, observed fund closures were sometimes the consequence of products, such as guaranteed funds, reaching maturity rather than the result of fund rationalisation efforts. Some consolidation has been taking place at national level. However, the absence of a common EU framework for fund mergers leads to the coexistence of different national rules, rendering cross-border mergers expensive, complex and time consuming when at all possible. Other amalgamation techniques such us entity pooling[29] are explicitly ruled out by the diversification requirements of the UCITS Directive.

Therefore, the WPIA concluded that two measures would allow the fund industry to fully exploit potential economies of scale: 1) a legislative framework for (cross-border) fund mergers and 2) the possibility for UCITS to engage in entity pooling.

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25 During the period 2003-06, the average size of American funds has increased by 35% and that of European funds by 42%.

26 According to CRA (European Commission (2006e)), the highest potential for economies of scale lays in fund administration and asset management. Although additional scale savings fade out once the fund's size has reached €200-300 million, the fact that a high percentage of European funds are far from that size as indicated by FERI data above, proves the importance of the economies of scale potential.

27 "Economies of scale and consolidation in collective funds", Fitzrovia, March 2005.

28 According to a recent Invesco report, this savings would stem from two sources. First, the elimination of the disappearing funds' fixed costs. Second, through the economies of scale achieved by a larger (resulting) fund. Please see Invesco (2005)

29 For more details on this technique please see the corresponding fiche in annex 7.

Table 2: Problem matrix

	Problem	Consequences
1	Barriers to marketing funds in other Member States' markets	• Missed opportunities for the industry • Higher costs and less choice for investors • Less competition in national fund markets
2	Proliferation of funds of small size	• Unexploited economies of scale • Confusing fund ranges
3	Lack of flexibility in organising the industry value-chain	• Resources duplication • Unexploited economies of scale • Untapped specialisation gains
4	Ineffective investor disclosures (simplified prospectus)	• High costs for industry • Little use for investors

Problem 3: Lack of flexibility in organising the industry value-chain. Although a passport for the management company was introduced funds of a corporate type[30] with the Directive amendments in 2001, the possibility for the management company to offer its services across borders is restricted in practice. Ambiguities in the Directive text and split supervision concerns have rendered it non operational. The relevant Directive provisions lack the necessary clarity and safeguards to allow the appropriate supervision by regulators of remote-managed structures. As a result, fund groups are obliged to establish a fully-fledged management company in each MS where they wish to base a fund range. This not only limits the capacity of the industry to achieve economies of scale and specialisation, but also leads to a duplication of resources that raises costs. Between € 381 and € 762 million could be saved annually if each European managing group could carry out its activities through a single management company. The fact that the original passport was limited to funds of a corporate type also reduces the potential benefits of the passport. Funds of a contractual form are the most common type of fund in 18 MS and the only existing type of fund in 13 of them.

The WPIA recommended exploring possible changes to the management company passport provisions in order a) to eliminate ambiguities, b) to extend it to funds of a contractual type and c) to enhance regulators' cooperation mechanisms.

30 'Corporate UCITS' or investment companies are UCITS constituted under statute. They generally have a Board of directors and investors (shareholders) can be entitled to vote in general assemblies. Corporate UCITS have a legal personality. On the other hand, 'contractual UCITS' are constituted under the law of contract (common funds) or trust law (unit trusts). They do not have a legal personality.

Problem 4: An ineffective simplified prospectus. Despite the clarification efforts provided by the Commission Recommendation in 2004[31], the simplified prospectus has failed in its mission to provide investors with a useful tool on which to base their investment decisions. The simplified prospectus is too long and complex and, thus of limited value to the investors. The information provided is not always easily understood by the average retail investor and it does not lend itself to comparison between funds, especially across borders. At the same time the production of the simplified prospectus is relatively costly and time-consuming for the industry as national requirements often add to those of the Directive and can differ widely across MS.

The WPIA suggested pursuing a new approach for the simplified prospectus, i.e. changes to the Directive focusing on the core principles for investor disclosures and possibility of defining the details (e.g. format and content) at level 2.

A more detailed description of the identified problems is provided in annex 7.

3.2. Objectives

The WPIA identified the following objectives. These remain the same for this IA exercise.

Overall objectives

The objective is to ensure that all players, asset managers, intermediaries and investors, can exercise their respective single market rights. Market players should be in the position to fully benefit from the single market freedoms and investor protection safeguards established by the UCITS Directive, as well as from the efficiency gains that an up-to-date legislative framework should facilitate. These single market opportunities not only concern the freedom of the industry to do business but also the freedom and right of investors to participate in the market in a fair and transparent way.

Specific objectives

The pan-European legal framework for harmonised funds should:

i) promote an efficient and innovative fund industry that is attuned to the needs of its traditional retail investor base, reaping all the commercial opportunities in a fully integrated European market and that is able to compete globally. In doing this, particular attention should be given to the need to reduce *administrative burden*.

ii) provide an appropriate protection of investors that takes into account market developments and changes in investors' needs and preferences, interactions with competing products as well as country-specific differences.

Operational objectives

The operational objectives are the deliverables that the amendment to the UCITS Directive should produce. The legislative changes aim to produce economic benefits, to promote the development of the industry and to strengthen the protection of investors.

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[31] Commission Recommendation 2004/384/EC of 27 April 2004 on some contents of the simplified prospectus as provided for in Schedule C of Annex I to Council Directive 85/611/EEC.

The concrete specific and operational objectives of each of the individual measures are summarised in tables 4, 6, 8, 10, 12 in section 4. They are also described in detail in annex 7.

3.3. White Paper recommendations

On the basis of the WPIA analysis, the White Paper future work to develop possible changes to the Directive in relation to five issues: 1) notification procedure, 2) fund mergers, 3) asset pooling, 4) render operational the management company passport and 5) simplified prospectus. The following table summarises the WPIA option analysis in relation to these issues.

Table 3: Summary of impact assessment for individual problem areas

(Preferred options are marked in bold)

	Assessment of impact on:			
Available options	**Efficiency**	**Market integration**	**Investors' protection**	**Feasibility**
1. Notification				
Service Passport replacing notification	++	++	--	Doubtful
Amend UCITS Directive: deadlines for procedures; regulator-to-regulator notification	++	++	++	Yes
Monitoring and support of CESR work towards more efficient and harmonised procedures	+	+	+	Yes
Do nothing	-	-	-	
2. Fund mergers				
Amend Directive: enable fund mergers	++	++	++	Yes
Soft law: support convergence of national approaches	?	?	+	Yes
Do nothing	-	-	-	
Taxation Directive: ensure that mergers are not treated as taxable events	++	++	+	Doubtful
Interpret. Communication: application of national rules to cross-border mergers	+	+	+	Yes
Do nothing	-	-	-	
3. Pooling				
Amend Directive to allow entity pooling	++	++	++	Yes
Amend Directive to allow master-feeders	+	++	++	Yes
Do nothing	-	-	+	
4. Management Company Passport				
Amend Directive to make the passport work: fine-tuning of existing provisions/elimination of potential inconsistencies in the rules	++	++	++	Possible
CESR guidelines to give effect to Art. 6c cooperation provisions	?	?	+	Doubtful effectiveness
Two-step approach: analyse situation + act on the basis of results	+	+	++	Doubtful effectiveness
Do nothing	-	-	+	
5. Simplified Prospectus				
CESR guidelines on coherent and uniform implementation of the SP	+?	+?	+?	Yes
Modify Recommendation to clarify certain elements of the Simplified Prospectus	+?	+?	+?	Yes
Abolish the Simplified Prospectus	++?	?	--	Doubtful
Amend Directive: specify core principles, Lamfalussy approach for future adaptations	++	++	++	Yes
Level 2 measure: clarification of definitions	+?	+?	+?	Yes
Do nothing	-	-	-	

Assessment: ++ = strongly positive; + = positive; -- = strongly negative, - = negative; ≈ = neutral; ? = uncertain;

Lamfalussy approach

The WPIA also encouraged, as a general rule, to undertake changes to the Directive following a Lamfalussy logic, i.e. focusing on core principles and leaving the definition of more technical details to level 2. This would introduce greater flexibility by allowing tailored adaptations of the legislative framework in line with the evolution of financial markets and both industry's and investors' needs.

Supervisory co-operation

The White Paper recognized that those changes to the UCITS framework would encourage cross-border operations and/or structures which could be more complex. Implementation of those changes will lead to a situation in which different regulators may be responsible for different actors and value-chain functions. Effective supervision will then need to be underpinned by an appropriate and timely cooperation between the relevant national authorities. The White Paper therefore concluded that the final design of the new provisions should include ways to enhance existing supervisors' powers and cooperation mechanisms. This recommendation has been fully taken into account in the analysis. However, given its close interaction with all of the other five issues, 'supervisory cooperation' has been dealt in this report as an intrinsic element of each of them rather than as a parallel issue[32].

4. DESIGNING THE LEGISLATIVE CHANGES PROPOSED IN THE WHITE PAPER

Ahead of the design of the new provisions, a number of choices (per issue) have been considered. These choices and their likely impacts are presented shortly in the sections below. Impacts summary tables have been inserted in order to provide a brief indication of the extent to which the respective choice would have an impact on efficiency, market integration and investor protection. Together with the accompanying text, these tables offer a very condensed summary of the impact assessments that have been prepared for each of the five individual issues. More detailed analyses can be found in annex 7. The table in annex 2 provides an overview of the impacts for all the issues analysed.

4.1. Addressing barriers to marketing funds in other MS markets (problem 1)

4.1.1. The notification procedure

The WPIA recommended amending the Directive in order to:

a) significantly reduce notification delays;

b) replace the procedure by a regulator-to-regulator communication exchange (following the example of other financial services Directives); and

c) remove legal uncertainties regarding regulators respective roles and responsibilities.

On that basis, the exposure draft published in March 2007 presented an overhaul of the notification procedure. It put forward a direct transmission from the home regulator to the host regulator of a (exhaustive) list of documents; allowing marketing 3 days after this

32 To facilitate the consultation process and the analysis of responses, the exposure draft (annex 4) however treated 'supervisory cooperation' as a stand-alone issue.

transmission. According to the proposal, the authorities of a host MS could not oppose the marketing of duly authorised UCITS in the host Member State.

Responses to the exposure draft consultation were generally supportive of the proposals but raised some investor protection considerations. These have been fully taken into account in the analysis carried out. Respondents' expectations are also reflected on the objectives that have guided the assessment of impacts (please see table below).

Table 4: Problem-Objectives-Solution

Problem area	Overall objective & detailed specific objectives	Detailed operational objectives	Recommended solution
Barriers to marketing funds in other MS markets	- eliminate barriers to integration of the European fund market => easier market access; greater competition - encourage cost and time savings => improved competitiveness of UCITS - appropriate investor protection	- wider national fund offer - greater business opportunities - more levelled playing field between UCITS and competing products - less administrative burden - investor protection levels maintained	Streamline the notification procedure

In order to streamline the notification procedure along the lines recommended by the WPIA (and informed by the exposure draft consultation) two possibilities have been identified:

1) maintain host MS regulator <u>ex-ante</u>[33] verification of the UCITS marketing arrangements but reducing the period available for that verification;

2) allow immediate marketing of UCITS in the host market after the notification: host MS regulator's checks takes then place <u>ex-post</u> on an <u>on-going</u> basis.

As explained in the more detailed analysis carried out in annex 7, the first option (ex-ante verification) would not improve significantly the current situation. The costs linked to the notification procedure (notably notification and legal fees) would most probably not diminish perceptibly. Uncertainty about UCITS time-to-market in the host MS would also remain[34]. The notification procedure would then continue to act as an entry barrier to national host markets. This will reduce the fund offer available to host investors and hold back competition forces (as well as their positive effect on the fund charges paid by the investor).

Accordingly, only a decisive simplification of the procedure would produce a significant positive effect. This is achieved by the second option (on-going ex-post checks). It has been argued that eliminating host MS regulator's ex-ante controls may undermine investor protection. The analysis of impacts however concludes that this risk is fairly small. Even in the absence of those pre-checks, there would still exist three levels of protection. First, the authorisation provided by the fund home regulator who checks compliance with the UCITS Directive provisions. Second, the fact that an important percentage of UCITS distribution in

33 That is, before the UCITS has been placed into the market of the host MS. (Likewise, 'ex-post' controls take place once the UCITS is already marketed in the host MS).

34 Requests for clarifications or additional information on the side of the host regulator could actually have the effect of prolonging the fixed period given to the host regulator for the verification. 'Stopping-the-clock' is already a normal practice and the two-month period currently provided for in the UCITS Directive not always respected.

host markets is done through EU or national regulated actors (e.g. around 75% of fund distribution takes place through actors regulated by the MiFID). Third, the preventive effect of ad hoc ex-post checks[35] that should deter breaches of the relevant rules. A procedure much simpler than (costly and cumbersome) systematic ex-ante verifications could therefore achieve the same level of investor protection. A number of parallel (also more proportionate) measures could reinforce the attainment of that objective. It has for example been suggested that host regulators make public the laws and provisions with which UCITS will need to comply in their territories. This approach has been already adopted by a number of MS.

Table 5: Notification: Summary of impacts

	Specific Objectives			**Overall Objective**
	Investor protection	**Efficiency[36]** **administrative burden**	**Efficiency[36]** **sector efficiency**	**Pro Single Market?**
Ex-ante control	+ *(no investor protection risk)*	- *(higher burden)*	- *(higher costs; less business opport.)*	no *(barrier entry to host market)*
Ex-post on-going control	+/≈ *(current protection levels maintained)*	+ *(lower burden)*	+ *(lower costs; more business opport.)*	yes *(will encourage market integration)*

Other procedural choices have been made in the detailed IA presented in annex 7. Most of them aim to (further) simplify the notification procedure. One that deserves particularly to be highlighted is the proposed choice regarding the language regime applicable to the documents that the notification file needs to contain.

The analysis recommends that only key investor information would be translated into the official language of the host MS. Translation costs and the long time needed for translations, often act as a barrier to entry into other MS markets (particularly small ones). Requiring only translation of the key investor information would entail a considerable reduction of the administrative burden borne by the industry (and ultimately passed on to investors in the form of higher fees) and improve UCITS time-to-market. It would also effectively respond to a practical reality (investors make generally little use of most fund documents due to their complexity). The envisaged review of investors' disclosures (please see section 4.4 below) should ensure that even if only the key investor information is translated a proper protection of investors is guaranteed. A few voices have however expressed concerns about this choice. In order to overcome them, a compromise solution could be to indicate in the key investor information in which language(s) the other fund documents would be available. The investor could then decide by him/herself whether this poses any problem to him/her. (It should then remain up to the fund provider to decide what fund documents, other than key investor information, need to be translated for commercial reasons.)

35 As well as fund promoter's natural interest to minimise reputation risks

36 Administrative burden refers to the costs linked to the production/provision of information that would have not been collected/provided in the absence of a legal obligation. Sector efficiency refers to efficiency gains derived from lower fund production costs, more rationalised processes or the greater flexibility and opportunities offered to industry players.

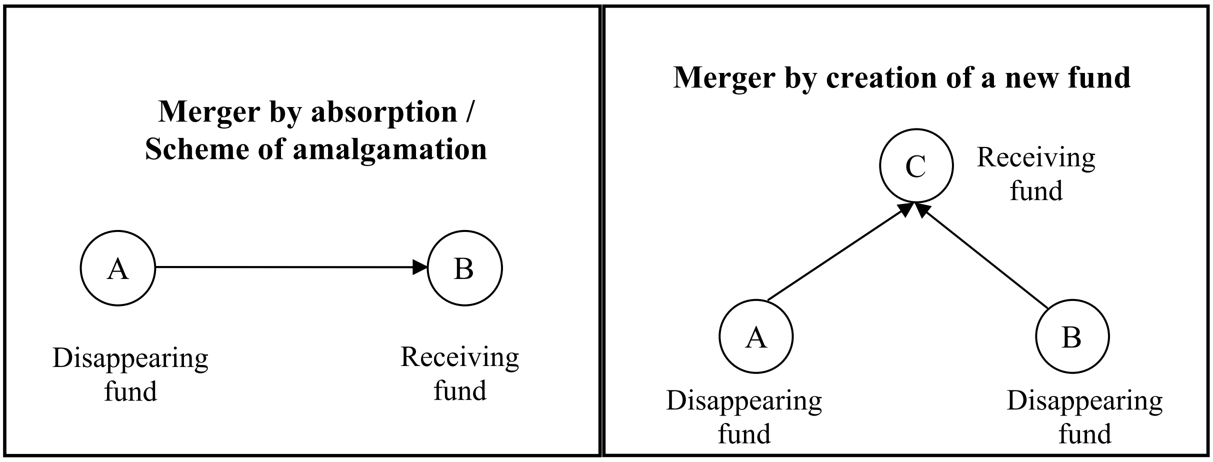
4.2. Addressing the proliferation of funds of a small size (problem 2)

The WPIA put forward two solutions in order to achieve economies of scale in the management of assets: facilitating fund mergers and enabling asset pooling. The reason for this was that, although both may pursue a similar goal, they serve different business logics. Mergers would be more appropriate for industry players wishing to offer a (cross-border) fund range from a single location; while pooling would be the rationalisation technique chosen for those offering a range of (national) funds established in several MS.

4.2.1. Fund mergers

The WPIA recommended changes to the Directive in order to create the conditions for the rationalisation of the fund landscape while, at the same time, ensuring high levels of investor protection. The exposure draft presented stakeholders with a preliminary design of an EU framework for UCITS mergers. The proposed framework would cover a series of commonly used merger techniques (please see diagrams below) and would apply to both domestic and cross-border mergers. A set of requirements for the regulatory approval of mergers was put forward, the main principle being that only the regulator of the disappearing fund would approve (or refuse) the proposed merger. The exposure draft also contained specific investor protection provisions, including the right for investors to receive information on the merger (particularly on its potential impact on them) and the right to redeem free of charge if they do not agree with the merger operation.

Figure 6: Fund merger schemes



The proposed approach was generally supported by all types of stakeholders (industry, regulators and investors). However, some investor protection concerns were voiced in relation to the proposed investor rights and, in particular, regarding the conditions under which investors of the receiving fund could exercise them. Responses have proved very useful in order to refine the objectives (please see the table below) and the principles of a fund merger framework.

Table 6: Problem-Objectives-Solution

Problem area	Overall objective & detailed specific objectives	Detailed operational objectives	Recommended solution
Proliferation of funds of small size	- eliminate barriers to integration of the European fund market - encourage cost savings at different levels of the value chain => improved competitiveness of UCITS - appropriate investor protection	- consolidation of the fund industry - economies of scale realised - simple and swift merger procedure - properly informed investors with the right to dissent	Enabling framework for fund mergers

In order to address the investor concerns expressed during the consultation, the IA developed in annex 7 analyses two possibilities regarding the provision to investors of information on the merger (the conclusions could then be extended to other investor's rights, such as the right to redeem free of charge):

1) Information on the merger is only provided to the investors of the disappearing fund

2) Information on the merger is provided to both investors of the disappearing and of the receiving funds[37]

The analysis of impacts concludes that none of these options are fully satisfactory from both an efficiency and an investor protection point of view. The first option minimises the administrative costs for the industry but gives rise to some investor protection concerns; the second minimises investor protection risks but is overly onerous. The rationale behind the first option is based on the practical reality of fund mergers. Those most affected by the merger operation are the investors of the fund that will disappear. Receiving fund investors remain invested in the fund that they had originally chosen and that maintains its main features, notably its investment policy.

However, the merger can also have an effect on those investors. When the disappearing fund is relatively big or when the portfolio composition of both funds is very different, the transfer of assets into the receiving fund may have a negative effect on its performance[38]. This performance dilution risk does not seem to be significant; there exist well-known techniques to minimise it (already often used in order to deal with big subscriptions or redemptions into/from a fund). However, although small, the risk remains. Providing receiving fund investors with information on the merger would enable them to protect their interests; but this appears to be a rather disproportionate measure. It may also discourage fund mergers (particularly cross-border) thus hindering further market integration.

Therefore, option 1, i.e. informing only investors of the disappearing fund, remains the most cost-effective one. However, the analysis in annex 7 concludes that this option should be accompanied by other parallel investor protection provisions. It is for example recommended that the regulator responsible for approving (or rejecting) the merger proposal would assess

[37] A third option would be 'no information to investors at all' but this is, for obvious investor protection reasons, deemed as unrealistic.

[38] For instance, due to the transaction costs associated to the rebalancing of the receiving fund's portfolio.

the potential impact of the merger on the investors of the receiving fund and decide, if appropriate, that these investors are also adequately informed about the merger's characteristics and possible impacts. Since the main negative potential impact on the investors of the receiving fund is of a purely technical nature (i.e. the dilution of performance mentioned above), the regulator of the disappearing fund should be able to asses that risk (as it is already currently done for national mergers) independently of where the receiving fund is based[39]. In any event, some form of communication or co-operation between regulators could also be considered. For example, the possibility for the regulator of the disappearing fund to consult with the regulator of the receiving fund before taking a decision. A combination of both possibilities (1 and 2) seems therefore the most advisable policy choice.

Table 7: Fund mergers: Summary of impacts

	Specific Objectives			**Overall Objective**
	Investor protection	**Efficiency** **administrative burden**	**Efficiency** **sector efficiency**	**Pro Single Market?**
Only to disappearing fund investors	- *(protection risk for receiving fund investors)*	+ *(lower burden)*	+ *(higher scale savings)*	yes *(potentially more mergers)*
To all investors	+ *(all investors duly protected)*	- *(higher burden)*	- *(lower scale savings)*	no *(may discourage mergers)*

4.2.2. Asset pooling

Two types of asset pooling were discussed in the WPIA: virtual pooling and entity pooling[40]. In the case of virtual pooling, the WPIA analysis left the door open to the introduction of a common approach but recommended to give further consideration to the issue. Subsequent research in this area led Commission services to conclude in the exposure draft that it did not seem appropriate at that stage to take any measure to create a pan-European environment for virtual pooling. Important cross-liability and other investor protection concerns were highlighted as the main reason. Additionally, it appeared that the use of virtual pooling was rare outside a few MS and that there did not exist cross-border experiences. Besides, there had not been strong demand on the industry side for such an environment[41]. Analysis of the issues blocking the cross-border development of virtual pooling should therefore first be discussed in appropriate fora.

With regards to entity pooling, the WPIA report concluded that the UCITS Directive should be changed to allow it. It also provided a first analysis of the scope of this new UCITS freedom. Two possibilities were considered: entity pooling in a broad sense and so-called 'master-feeder' structures. These concepts are described graphically in the boxes below.

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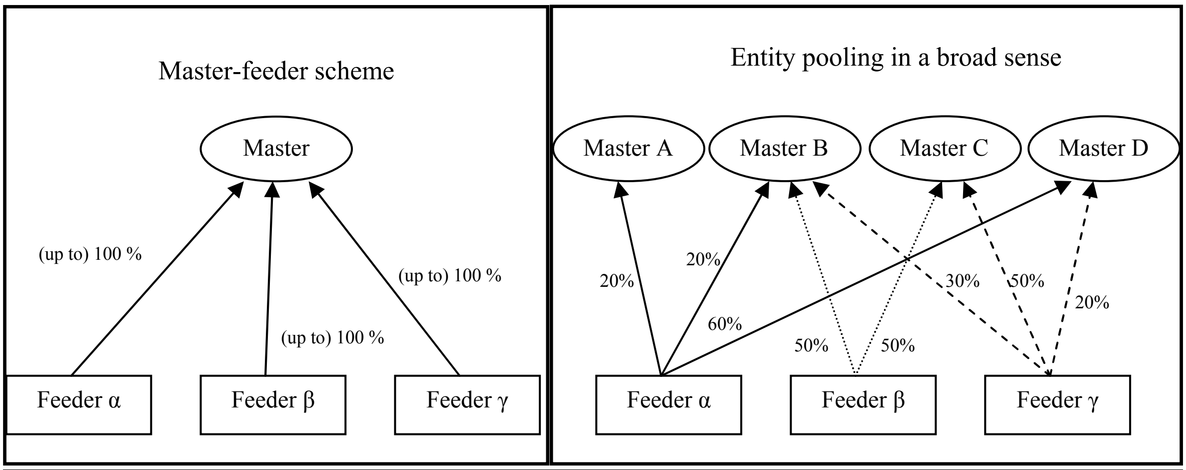
39 Given the technical nature of the performance dilution effect, no particular knowledge of the local rules in the country of the receiving fund should be required.

40 For a description of each of these techniques please refer to the IA fiche on asset pooling in annex 7.

41 Contributions to the consultations on the Green Paper and the Expert Group report on Market Efficiency had showed a greater interest for entity pooling (particularly master-feeder structures). Responses to the exposure draft have confirmed this position.

Figure 7: Entity pooling techniques



The exposure draft presented an outline of the changes to the UCITS Directive necessary to provide a framework for entity pooling. On the basis of a preliminary assessment of impacts, the exposure draft proposals concentrated on master-feeder structures. The main characteristics of that proposed preliminary framework were the following: a) prior regulatory approval of the feeder's investment into the master was required, b) pooling structures needed to have at least two feeders, c) the minimum investment of the feeder into the master was fixed at 85% (of the feeder's assets); d) proper arrangements between master and feeder (and between its depositaries and auditors) needed to be in place; e) information to investors should clearly explain the implications of the two-layer investment; and f) both master and feeder, as UCITS, needed to comply with the Directive provisions.

Respondents to the exposure draft consultation found the suggested framework rather prescriptive. They recommended to concentrate at level 1 (i.e. Directive changes) on key regulatory principles, leaving details on procedure or application of those principles to specific scenarios to be filled in through implementing legislation (level 2) or common supervisory practice. These level 1 principles should however respond to the expectations of the different stakeholders as reflected in the objectives listed in the table below.

Table 8: Problem-Objectives-Solution

Problem area	Overall objective & detailed specific objectives	Detailed operational objectives	Recommended solution
Proliferation of funds of small size	- eliminate barriers to integration of the European fund market - encourage cost savings at different levels of the value chain => improved competitiveness of UCITS - appropriate investor protection	- economies of scale realised - wider fund offer - greater management flexibility; limited additional administrative burden - investors properly informed - easy on-going supervision	Allow entity pooling

As regards the entity pooling technique selected (master-feeders structures), a majority of respondents supported this choice. There was however a number of contributors that invited the Commission to consider the introduction of a framework for entity pooling in a broad sense. For some of these, limiting the scope of this new market freedom to master-feeders was a serious missed opportunity. Taking into account the new arguments provided supporting each of the two entity pooling techniques the analysis of impacts has therefore focused on the following options:

1) Allowing entity pooling in a broad sense.

2) Allowing master-feeder structures.

As explained in the detailed IA analysis in annex 7, the possibility to use entity pooling in a broad sense could bring important advantages to industry players. Flexibility to tailor feeder funds' composition would allow fund promoters to adapt quicker their fund ranges to changing trends and investors' demands. It could however be argued that some of the advantages related to this technique are already available to industry players thanks to the current funds of funds regime[42]. Option 1) would entail allowing an UCITS to invest in more than 5 other funds. This relaxation of the diversification requirements for fund of funds could have significant unintended consequences for investors. Additionally, if the objective is to achieve economies of scale through the pooling of assets, this seems to be more easily attained through master-feeder structures (through entity pooling in a broad sense, feeder's assets would be split into a number of masters). Given the complexity of 'entity pooling in a broad sense' structures, additional investor information obligations may need to be imposed on fund providers. Thus, the impact on administrative burden of option 1) risks been greater. The IA analysis therefore concludes that the master-feeder option is to be preferred both in terms of efficiency and of investor protection.

Table 9: Asset pooling: Summary of impacts

	Specific Objectives			**Overall Objective**
	Investor protection	**Efficiency**		**Pro Single Market?**
		administrative burden	**sector efficiency**	
Entity pooling broad sense	- *(supervisory concerns)*	- *(higher burden)*	+ *(higher flexibility lower ec. of scale)*	yes *(will encourage market integration)*
Master-feeders	+ *(more well-known and positively tested)*	+ *(lower burden)*	+ *(less flexibility; higher ec. of scale)*	yes *(will encourage market integration)*

Further to determining the optimal scope of this new single market freedom, the IA fiche also provides concrete recommendations on how to simplify the design of the framework presented in the exposure draft. Thus, the analysis recommends abandoning the minimum two-feeder requirement (in favour of other more proportionate investor protection solutions) and to provide a certain degree of flexibility as regards requirements governing the relationship between the different actors.

42 A fund of funds is a fund whose portfolio is basically made of funds (and liquidity). The UCITS Directive includes a set of rules that UCITS fund of funds need to comply with; notably the obligation to invest in at least 5 funds.

4.3. Addressing the lack of organisational flexibility (problem 3)

4.3.1. Management Company Passport

The exposure draft tried to strike a balance between a comprehensive Management Company (MC) passport and supervisory concerns. The proposed framework included provisions to ensure a minimum of "substance" in the fund domicile (indicating the functions that should remain in that MS) and to enhance the supervisors' cooperation mechanisms. According to the exposure draft proposals, the fund domicile would be determined by using two criteria: 1) the country under whose laws the fund is constituted and 2) where the verification of the fund valuation and the maintenance of the unit-holders' register take place. The passport would be also extended to funds of a contractual type. The depositary would remain based in the fund domicile.

Contrary to the other four topics, responses to the exposure draft consultation expressed divergent views regarding the management company passport proposals. Industry respondents voiced their disappointment regarding the proposed scope of the passport. Others, mainly national authorities, considered that the proposed approach provided neither a clear definition of regulators' respective responsibilities nor the means to fulfil their supervisory duties. Some concerns were expressed regarding the risk of double taxation and the feasibility of extending the passport to contractual funds.

Table 10: Problem-Objectives-Solution

Problem area	Overall objective & detailed specific objectives	Detailed operational objectives	Recommended solution
Lack of flexibility in organising the industry value-chain	- eliminate barriers to integration of the European fund market => greater cross-border activity - encourage savings by eliminating costs duplication => improved competitiveness of UCITS - appropriate investor protection	- scale and specialisation gains realised - freedom to organise business structures cross-border - effective supervision - clear regulators' responsibilities	Make the Management Company Passport work

The divergence of positions expressed during the exposure draft shows how difficult the task of conciliating the objectives of greater flexibility and adequate supervision. Given the fundamental questions raised during the consultation, the analysis of impacts has concentrated on the following options:

1) Maintain the status quo (i.e. do nothing)

2) Make the MC passport work for corporate funds and extend it to contractual funds

3) Make the MC passport work for corporate funds

Commission's analysis suggests that the absence of a management company passport does deprive the industry of flexibility in domiciling functions and of costs savings. Work since the exposure draft has concentrated on the design of provisions which avoid regulatory gaps, uncertainty or overload by 1) clarifying the respective responsibilities of fund and management company supervisor, 2) providing mechanisms to allow the fund supervisor and depositary with means to monitor and enforce compliance with the rules in force in the fund domicile and 3) ensuring that the management company and its supervisor provide all necessary support to the fund supervisor and depositary.

Work on the design of effective provisions reveals that this would:

- Entail extensive information exchange and reporting obligations between fund management company, fund supervisor, management company supervisor, fund administrator and depositary.

- Leave open many concerns about respective responsibilities – fund supervisor and depositary would be largely dependent on the management company and the management company supervisor to discharge their obligations. Concerns exist that incentives and responsibilities would not be properly aligned

- Enforcement concern remains, particularly as regards contractual funds. As these are the only existing UCITS form in 13 MS, the economic impact of the management company passport only for corporate funds appears limited.

The IA therefore concludes that the type of provisions needed to provide a management company passport would entail extensive bureaucracy and administrative costs. They would not fully dispel the supervisory concerns and investor protection risks associated with cross-border fund management. They would provide neither a cost-effective basis to introduce the passport. Potential drawbacks are considered to outweigh the expected benefits. The Commission therefore proposes not to change at this stage the provisions of the Directive in this regard but to maintain the status quo whereby fund managers undertake cross-border management through delegation-based solutions. The Commission intends to ask CESR to provide advice on safe, efficient and cost effective solutions that can provide confidence in respect of a range of supervisory and risk management issues.

Table 11: Management Company Passport: Summary of impacts

	Specific Objectives			**Overall Objective**	
	Investor protection	**Efficiency** **administrative burden**	**Efficiency** **sector efficiency**	**Pro Single Market?**	**Feasibility**
Do nothing	+/- *(some operational risks)*	≈ *(status quo)*	- *(untapped savings)*	no *(barrier entry to service host market)*	*Not applicable*
Passport for all funds	-- *(concerns re. split supervision and contractual funds)*	-- *(burdensome procedure)*	++ *(lower costs; specialisation gains)*	yes *(will foster market integration)*	*Difficult (particularly re. contractual funds)*
Passport only for corporate funds	- *(split supervision concerns)*	-- *(burdensome procedure)*	+ *(some cost savings/ specialis. gains)*	yes *(will facilitate market integration)*	*Doubtful*

4.4. Addressing the ineffectiveness of the Simplified Prospectus (problem 4)

4.4.1. Key investor information

The WPIA not only considered an amendment to the UCITS Directive as the most effective solution but it also put forward a list of potential changes. These related to the length, the content and even the name of the Simplified Prospectus (considered by some as confusing).

In line with these recommendations, the exposure draft presented a completely new approach to investors' disclosures: the key investor information (KII) concept. It put forward the idea of a fair, clear and not misleading set of information, not necessarily embodied in a specific document. KII would include all the product information relevant for the investor to assist him/her in taking an informed investment decision, as well as practical information necessary for the investor to be able to exercise his/her rights. The planned changes to the UCITS Directive would concentrate on defining the high-level principles of the KII (purpose and main characteristics); the detailed provisions (content and format) would then be designed later (Level 2 measures). The table below summarises the objectives pursued with those proposed changes.

Table 12: Problem-Objectives-Solution

Problem area	Overall objective & detailed specific objectives	Detailed operational objectives	Recommended solution
Ineffective investor disclosures (simplified prospectus)	- eliminate barriers to integration of the European fund market - more cost-effective disclosure procedures => improved competitiveness of UCITS - improve competition and transparency in distribution - reduce risks and improve information and choice for investors => enhanced investor protection	- greater comparability between funds - effective tool to take an investment decision - less administrative burden - clear regulators' responsibilities	Simplify the Simplified Prospectus

The framework proposed in the exposure draft was generally welcomed by stakeholders. Nevertheless, respondents expressed different views regarding the fact that the proposal did not require the KII to be presented in a single document. The analysis in annex 7 therefore focuses on the impacts of two possible alternatives:

1) KII is provided in the form of building blocks not necessarily embodied in one single document.

2) KII is provided as a single stand-alone document

As described in annex 7, the building block approach would allow for greater flexibility regarding the presentation of the information. It would then be possible to better adapt disclosures to the type of investor and/or to the distribution channels and methods used. However, a single document would probably be simpler to use for investors. It would be easier for them to understand and to assess the virtues/drawbacks of the fund if all the relevant (or key) information is provided together. Investors will be able to compare between products and therefore to chose the one more in line with their needs. This ability to compare among funds should, in the medium term, encourage competitive forces and therefore put pressure on prices (fees). Additionally, from a compliance costs point of view, it should be noted that the building block approach represents an important change vis-à-vis the current situation. It would therefore probably imply higher adjustment costs for the industry.

Thus, a single stand-alone document appears to be the option that complies better with the objectives of investor protection and efficiency. Since it will allow a easier comparison among different MS funds, it should also encourage the integration of the European fund market.

Table 13: Key Investor Information: Summary of impacts

	Specific Objectives			Overall Objective
	Investor protection	Efficiency administrative burden	 sector efficiency	Pro Single Market?
Building blocks	+/- *(adapted disclosures but no global view)*	- *(risk of higher burden)*	- *(risk of higher costs)*	no *(less comparability, could act as entry barrier to host markets)*
Single document	+ *(more user-friendly)*	+ *(lower costs and administrative burden)*	+ *(lower costs)*	yes *(comparability will encourage market integration)*

Other practical choices have been made in the detailed IA presented in annex 7. Many of them aim to reduce the burden associated with the production and delivery of the KII. For example, clarifying the liability attached to the KII would help in reducing the complexity of the document (avoiding thus long and complicated legal disclaimers). Allowing the possibility to use different KII distribution methods (including electronic delivery) could have a positive impact on delivery costs.

4.5. The overall impact of the proposed measures

4.5.1. Overall impacts

The economic savings to be expected from the proposed measures are not negligible. They range from the modest identified savings of the new notification procedure (most of the current € 20 million initial notification costs and probably also the € 25 million annual costs of maintaining notification) to the several billion to be saved annually if European funds could fully exploit the economies of scale derived from consolidated management through fund mergers or asset pooling. The simplification of investors' disclosures, the possibility to use electronic transmission means and the recommended language regime (i.e. only KII is to be translated into the host MS language) will also entail important savings. These, although difficult to quantify, were considered as substantial by many respondents to the exposure draft consultation. The overall impact of the proposal on administrative burden is provided in the box below.

Impact on administrative burden

The guiding principles of this analysis have been market efficiency and investor protection. However, particular attention has also been given to the need to reduce administrative burdens.

As regards to already *existing mechanisms*, the recommended decisive simplification of the notification procedure and of investors' disclosures would lead to a significant reduction of those burdens. The recommendation to limit translation (into the host MS official language) to solely the KII is one of the key elements with regards to the notification procedure. While the corresponding reduction of administrative burden is difficult to quantify, one of the pan-European players contributing to the consultation on the exposure draft estimated savings of approximately one-third of its notification costs. To further alleviate the administrative burden linked to the notification procedure the content of the notification file should be clearly determined (and thus rule out host MS' requests for additional information). The shortening and standardisation of the contents of the KII will also be an important step forward, although savings are difficult to quantify at this stage (CESR is currently working on a recommendation to the Commission on the format and content of the KII). The possibility to use electronic means for the transmission of the notification file and to provide the KII to investors would also contribute to this savings.

Two of the proposals introduce *new freedoms* but also new obligations and therefore additional administrative burden; these are the framework for fund mergers and for asset pooling. It needs to be noted however that the harmonisation of the merger procedure sought by the new provisions would considerably reduce the administrative burden actually borne by fund promoters wishing to merger funds cross-border (and who currently need to comply with a set of different national requirements). In the case of pooling, the additional administrative burden appears justified by the need to ensure adequate levels of investor protection. Recommendations in relation to these two areas aim at rationalising the proposed framework by clearly identifying the respective responsibilities of the industry and competent authorities.

While the scale of those savings may not be seem as compelling in certain cases, important ***dynamic effects*** are also to be expected[43]:

- The shorter time-to-market for funds will enhance their competitiveness vis-à-vis other investment products.
- A more efficient notification procedure could also reduce the need to have different national fund ranges. A single cross-border fund could then pool the assets from investors in several MS and attain more easily economies of scale.
- The greater openness of national markets should encourage competition and encourage industry's players to pursue economic efficiency.
- Rationalised fund ranges through fund mergers should reduce confusion among distributors and investors and render investment choices easier. The fund offer will also benefit from the innovation possibilities offered by pooling.

[43] More details on the impacts per measure are to be found in annex 7.

- Enhanced disclosures will provide investors the necessary tool to take informed decision. The possibility to compare between funds should encourage competition and, thus, put pressure on fees.

Over the long run, these positive effects will contribute to the greater economic efficiency and competitiveness sought by the Lisbon strategy.

4.5.2. Synergies and trade-offs of the package of measures

These effects should however not been seen in isolation. Important synergies could be expected of the interaction of the different proposed measures. The most relevant are given by the combinations below. Synergies should reinforce, in the medium to long-term, the above individual impacts.

Notification procedure-KII: As often highlighted during the exposure draft consultation period, a swift notification procedure will up to a certain extent depend on the on-going work on the KII. A number of respondents to the exposure draft required the Directive to clarify that the KII was not to be considered as marketing material and thus, could be used without changes across borders (i.e. without interference of the host MS regulator).

KII-Fund mergers/asset pooling: Streamlined KII could play an important role helping investors to take an informed decision regarding the merger operation or the pooled structure presented to them. In the first case, it should facilitate the comparison between the funds merging and the understanding on how the operation will influence their investment. In the second, it would help to understand the implications for them of the double-layer investment.

Fund mergers-asset pooling: As already highlighted in section 4.2, fund mergers and pooling pursue similar goals (economies of scale in asset management). However, they are not to be considered as alternative but rather as complementary measures. Opting for one or the other will depend on the business model adopted: mergers might be more appropriate for industry players wishing to offer a (cross-border) fund range from a single location; pooling might be more appropriate for those offering a range of (national) funds established in several MS.

Notification procedure-fund mergers: It has been recommended that the receiving fund be notified to the relevant authorities in all MS where the disappearing fund is sold to investors. A simplified notification procedure would make it easier and quicker for the industry to comply with this requirement. The simplification of the notification procedure can also reinforce the consolidating effect of fund mergers. By achieving a greater openness of national markets, fund promoters will feel less the need to launch parallel ranges of funds in other to assure their presence in different MS.

4.5.3. Impact on investors

<u>Investor protection</u>: The analysis carried out has systematically tested the impact of the different proposed measures on investors. Contributions of investors' representatives during the whole UCITS review process have been key in order to identify the potential impacts and to assess their likelihood and importance. When a possible detriment to investors have been identified, solutions have been put forward in order to eliminate it; the objective being maintaining the high levels of protection already enjoyed by UCITS investors.

Economic benefits: The assessment has identified clear and direct benefits for stakeholders. Often these seem more straightforward in the case of industry players. Investors are however also to benefit importantly, although in certain cases, advantages will only materialise over time. The positive effects of the package of measures will flow to investors through four distinct channels:

a. Some efficiency savings will take place directly at the level of the fund. The proposed framework for fund mergers and asset pooling will allow managers to put in the market bigger orders and thus, obtain better execution prices. Lower transaction costs will have a positive effect on the fund's performance from which investors will directly benefit.

b. Thanks to the streamlining of the notification procedure and the greater competition in national markets that this will bring about, fund promoters will need to find new ways to attract or keep clients (e.g. through additional services or lower fees)

c. Studies have shown that distribution is an important source of costs and that the bargaining power of distributors is high. For the package savings to be passed on to investors, it is also necessary to act at the point of sale. MiFID conduct of business requirements will oblige distributors to put the interest of investors first.

d. Investors have also the possibility of accelerating the process of passing through of the savings. Improvements on investors' disclosures (KII) aim at empowering investors. Clear and standardised information will help them to compare among funds and assist them in taking an informed investment decision. This should strengthen their ability to push for more competition between fund providers.

Finally, it needs to be noted that, although 'investors' in this report and its annexes mainly refer to the physical person investing in UCITS, institutional investors represent an important part of the UCITS' 'client base'. Some, such as insurers and pension funds, invest more than 20% of their assets in UCITS[44]. They will therefore not only importantly benefit from the identified efficiency gains but also reinforce the positive dynamic effects of the package of measures on the economy.

4.5.4. Impacts on the industry organisation and global competitiveness

Employment level: the European fund industry being a non-labour intensive sector, the impact of the package of measures on employment should be minor. The economies of scale pursued by the fund merger and asset pooling measures should not lead to a reduction of the relevant work force, especially considering that the continued launching of new funds (due to financial innovation and changes in investors' needs/preferences) is an important counterbalancing trend in this respect.

Industry organisation: While the package of measures should not have an important impact on the organisation of the European fund industry, greater integration and new business possibilities should lead to a concentration of certain activities in the most efficient fund centres. Well-established centres already enjoying a good repute should be able to make the most from the package of measures.

[44] EFAMA Fact Book 2007.

Effects beyond EU borders: The proposed package of measures will have, as explained, an important positive effect on the development of the European fund industry. The identified impacts have also a global dimension. On one hand, strong levels of investor protection will reinforce the attractiveness of the UCITS brand beyond EU borders. Enhanced efficiency and lower costs will also assist UCITS funds in facing global competition. This should help UCITS to reinforce the privilege position they already enjoy in Latin America and Asia markets as well as to enter new ones. On the other hand, a more integrated market will act as a magnet for international players wishing to have access to the savings of a pool of 493 million investors[45]. The on-going regulatory dialogue with third countries such as the US, Russia and China should ensure that UCITS changes are well understood outside the EU.

4.6. Other general considerations

Impact on SMEs: EU initiatives have sometimes been criticised for favouring mainly big pan-European players. The proposed UCITS changes will however have also a positive impact on smaller players (including SMEs). Firstly, as investors, they would have access to more efficiently managed funds (notably important with respect to their treasury management). Secondly, as fund promoters, they will have easier and cheaper access to new markets from where they were excluded for economic reasons (e.g. notification fees, translation costs of investor disclosures or management company related costs). They could also more easily complement 'in-house' expertise thanks to the new pooling possibilities[46].

Impact on the EU budget: The proposed measures do not have an impact on the EU budget.

Realisation of the impacts: While no specific transposition difficulties are anticipated, realisation of the expected impacts will also depend on the form (and implementation) of the more detailed (technical) provisions to be developed through implementing measures at level 2. CESR is however developing its own IA methodology[47] along the lines of the Commission's IA guidelines. The design of level 2 provisions would therefore in the future also benefit from an analysis of the options available and their impacts.

Environmental impact: The streamlining of the KII and the possibility to use electronic transmission means will have a positive environmental impact. However, this should remain marginal given the size of the environmental challenges we face.

5. MONITORING AND EVALUATION

General monitoring of the European investment fund market framework already includes the following elements:

– Monitoring of the implementation of Market in Financial Instruments Directive (MiFID) and its impact on UCITS. (MiFID-UCITS vademecum to be published in spring 2008)

45 Eurostat 2006 data.

46 Pooling is sometimes used to offer investors a fund managed by another (well-known) asset management team/group but with the brand of the fund promoter itself ('white labelling').

47 In May, CESR submitted for consultation its proposed IA methodology. CESR is currently reviewing its document in line with the contributions received (the consultation deadline was 24th August).

– Study on investment policies of harmonised (i.e. UCITS) and non-harmonised funds, evaluating the use actually made of the enlarged investment powers introduced by the 2001 amendments (end 2007)

– Study on the sale of non- harmonised funds in the EU (end 2008)

– Commission report on the need and identification of possible options for developing the single market framework for certain retail-oriented non-harmonised funds.

– European Financial Integration Report (annually)

Monitoring of the proposed legislative changes would imply following the indicators listed in the table below.

Table 14: Monitoring indicators

Issue	Indicators	Source of verification
Notification	• Number of funds notified in other MS • Notification costs (including regulators' fees) • Number of local marketing rules infringement cases	PWC, FERI data Industry organisations CESR
Mergers	*Short-term indicators* • Number of cross-border mergers • Length of the merger process *Long-term indicators* • Average fund size • Average fund costs • Number of investor protection related complaints	FERI, Lipper data Industry organisations CESR
Pooling	• Number of master-feeder structures • Average size of the master • Average fund costs • Number of investor protection related complaints	Industry organisations CESR
Key Investor Information	• Length of the KII • Comprehensibility of the KII • Number of investor protection related complaints	Stakeholders' feedback (particularly investors)

Provisions of the amended UCITS Directive could also foresee a formal evaluation of the changes (e.g. four years after it enters into force). Given the difficulty to measure at this stage of the legislative proposal a number of impacts, that evaluation could also focus on a more comprehensive quantification of the effects of the Directive amendments.

ANNEX 1: Procedural issues and consultation of interested parties

Chronology

The five-year Financial Services Action Plan (FSAP) launched in 1999 very much concentrated on the completion of the single market for wholesale services. Towards the end of the FSAP period, it was clear that other areas would need close attention after 2004. In preparation of the strategy for the post-FSAP, the Commission set up four groups of experts of which one focused on improvements to be done in the area of asset management.

Since then, the Commission has launched a process of analysis and design of possible solutions on the basis of inputs of a very different nature. These ranged from bilateral informal meetings with stakeholders to studies, further expert groups, open hearings, public consultations and workshops. Many of these events brought together different stakeholders in order to better design and assess the implications of possible actions on each side of the market. Most of these exercises have been open and largely documented on the Commission's website. The openness and transparency of the process has been highlighted and acknowledged frequently by stakeholders. The milestones of that process are summarised in the table below.

Table: Chronology of the preparatory process

Date	Item
2004	
May	FSAP Expert Group on Asset Management Report
10th Sept.	End of the expert group report's consultation period
2005	
14th July	Green Paper on the enhancement of the framework for investment funds
September	White Paper Roadmap
13th Oct.	Open Hearing on the Green Paper
21st Oct.	Start of "Potential Cost Savings" study
15th Nov.	End of the Green Paper's consultation period
21st Dec.	Start of "Current trends" study
2006	
31st Jan.	Establishment of two Expert Groups
8th March	1st meeting of the Inter-service Impact Assessment Steering Group
15th May	1st Workshop on the Simplified Prospectus
19th May	2nd meeting of the Steering Group
4th July	Final reports of the Expert Groups published
11th July	2nd Workshop on the Simplified Prospectus
18th July	3rd meeting of the Steering Group
19th July	Open Hearing on the Expert Groups' reports
Aug./Sept.	Final report "Potential Cost Savings" and "Current trends" studies
8th Sept.	4th meeting of the Steering Group
15th Nov.	Adoption of White Paper on investment funds
16th Nov.	Publication of White Paper and Impact Assessment
2007	
6th March	1st meeting of the re-established Inter-service IA Steering Group
22nd March	Publication of DG Markt's working document 'Initial orientations on changes to the UCITS Directive' (also referred to as 'exposure draft')

26th April	Open Hearing on the exposure draft
15th June	End of the exposure draft consultation period
13th July	2nd meeting of the (re-established) Inter-service IA Steering Group
18th Sept.	3rd meeting of the (re-established) Inter-service IA Steering Group
26th Sept.	Submission of draft report to IA Board
24th Oct.	Decision of the IA Board

Consultations

As described in the main report, the asset management expert group's report published in May 2004, identified a list of issues requiring action. Reponses to the open consultation showed that there was a widespread consensus on the fact that there was considerable room for improvement in the EU legislative framework regulating asset management.

The Commission Green Paper (July 2005) identified concrete steps in this direction. It proposed a series of actions in the short-term and launched a debate on the need for a more wholesale reform of the investment funds legislative framework in the medium to long-term.

Views expressed during the Open Hearing on the Green Paper (October 2005) and during the open consultation (mid-July to mid-November 2005) widely agreed with the Green Paper's approach for the short-term, that is, improving the implementation of the provisions of the existing framework[48].

The European Parliament has also contributed to the debate with an own-initiative report adopted in April 2006[49]. The report main conclusions are that:

- there is no need for a complete make-over of UCITS Directive;
- it is however necessary to make the UCITS Directive evolve in line with changes in the market through a combination of better implementation of existing provisions and targeted adjustments or additions to the Directive;
- any legislative adjustments to the Directive should integrate the possibility for adoption of detailed implementing legislation via comitology (Lamfalussy procedure). [please see annex 4]

In July 2006 the recommendations of the Expert Group[50] on Market Efficiency were published[51]. The general public was invited to discuss the reports at the occasion of an open hearing which took place 19th July[52] or in writing during the following two months.

The hearing showed that the industry's views on efficiency issues are very much in line with the views of the Parliament report. Responses to the consultation provided a valuable input for the completion of the WPIA report.

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48 A summary of the conclusions of the Open Hearing can be found at: http://europa.eu.int/comm/internal_market/securities/ucits/index_en.htm#hearing The Feedback Statement on the Green Paper consultation can be found at: http://europa.eu.int/comm/internal_market/securities/docs/ucits/greenpaper/feedback_statement_en.pdf

49 European Parliament's report on asset management (2006/2037(INI)), March {27/03/2006} 2006 (also called the Klinz' report).

50 For more information on its mandate please see section 'expert groups' below.

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

52 http://ec.europa.eu/internal_market/securities/ucits/index_en.htm#060607, a flash report summarising the discussions is also available on this website.

Other informal consultations of stakeholders during 2006 have taken place using ad hoc questionnaires to CESR[53] and EFAMA[54]. These have focused on specific issues such as the use of the management company passport or on the taxation of fund mergers.

In March 2007, DG Markt published a working document (exposure draft) presenting its initial orientations on the possible shape of the amendments to the UCITS Directive. The overview document published at the same time is provided in annex 3.

A well-attended open hearing on 26th April provided stakeholders' first reaction to the exposure draft proposals. A summary of the open hearing discussions was published shortly afterwards[55]. Written reactions to the working document were published on 26th July. A summary of the responses were published on 7th September. Details on the main comments received per topic from respondents are provided in the detailed IA fiches annexed to this report.

Table : Compliance with consultations minimum standards[56]

	Clear content	Target groups	Publication	Time limits	Feedback
AM expert group report	Yes (list of recommendations)	• Regulators • Investors • Industry	Internet	06/05 – 10/09	Published in Nov. 2004
Green Paper	Yes (list of questions)	• Regulators • Investors • Industry	Internet + hard copies distributed at open hearings	12/07 – 15/11	Published on 13/02/06
Market Efficiency expert group report	Yes (recommendations per topic)	• Regulators • Investors • Industry	Internet + hard copies distributed at open hearings	04/07 – 20/09	Published on 16/11/06
Exposure draft	Yes (possible drafting of legal provisions)	• Regulators	Internet	22/03 – 15/06	Published on 07/09/07

53 Committee of European Securities Regulators.
54 European Fund and Asset Management Association.
55 This can be consulted at http://ec.europa.eu/internal_market/securities/ucits/index_en.htm#hearing
56 On the based of the recommendations in the Commission Communication "Towards a reinforced culture of consultation and dialogue - General principles and minimum standards for consultation of interested parties by the Commission" COM (2002) 704 final

- Investors
- Industry

Expertise

(1) Studies:

In order to complement internal research and public consultations' results with empirical data, two studies were launched in 2005:

– The "Current trends in the European Asset Management industry" study aimed at providing historical series of asset management related data relevant to understand the functioning of the industry and how it has been evolving over the years. It provided useful data to develop the 'context' section of the WPIA.

– The "Potential cost savings in a fully integrated European investment fund market" study aimed to present a detailed comparative description of the main sources of cost in the EU investment fund value-chain and an estimation of the savings that could be achieved by enhanced market integration. This study helped to quantify the effect of several barriers to the single market for funds and provided some estimates used in the 'assessment of options' section of the WPIA.

(2) Expert Groups:

Expert groups were established at two stages of the process:

– Independent expert group on the review of the FSAP (asset management) in 2004. This group identified a series of actions needed in order to improve the functioning of the European fund market. Their work was key for the development of the analysis that led to the Green Paper.

– Two expert groups were set in 2006 to further explore the need and form of possible measures with regards to market efficiency and alternative investments (namely private equity and hedge funds). The first group advised on how to give effect to some of the actions recommended by the asset management expert group (notably those considered as priorities by stakeholders during the consultations on the 2004 expert report and on the Green Paper). Most of them are covered by the legislative measures announced in the White Paper and are dealt with in this report. The group on alternative investments helped in developing an understanding about some forms of collective investment schemes that are growing outside the UCITS framework.

(3) Committee of European Securities Regulators (CESR):

(Although the UCITS Directive as a whole is not a so-called Lamfalussy Directive some "Lamfalussy" elements were introduced with the 2001 amendments. These allow for clarifications of definitions to be developed through (level 2) implementing legislation, adopted via comitology procedures. For details on the Lamfalussy approach to legislation see Annex 4.)

CESR has contributed to and supported the Commission's efforts to improve the legislative framework for UCITS with various consultations and advice on different subjects as well as with fruitful discussions and contributions. Concretely, CESR has provided the Commission with advice on UCITS eligible assets and adopted guidelines on the transitional provisions of the 2001 changes to the Directive and on the notification procedure. The work on eligible assets was translated into implementing measures (adopted in March 2007). The notification guidelines represent a first step towards a more streamlined procedure. Their effectiveness is however restricted by their voluntary nature and by the fact that they were developed within the limits of the existing Directive (and can therefore not solve the problems inherent to the Directive's current drafting). CESR is currently working on the contents of the new simplified prospectus (please see 'key investor information' section). This is an important preparatory effort ahead of the level 2 work that would be required once changes to the Directive in this area are introduced.

In April 2007, Commission services presented their exposure draft to CESR members. One of the main conclusions of the discussion was that substantial work still needed to be done in order to enhance supervisory trust and cooperation. Exchanges within CESR on this issue during the following months have importantly contributed to the development of the relevant provisions of the draft legislative proposal, notably in the areas of notification and management company passport.

(4) Financial Services Consumer Group, FIN-USE

One of the challenges faced in financial services consultations (particularly when the subject is as technical as in the UCITS case) is the risk of not receiving the views of all relevant stakeholders. In fact, investors representatives' responses are often less numerous than industry's ones. In order to reinforce the input of investors into the process, Commission services have worked closely with several groups representing investors' interest.

Thus, the Green Paper and the Commission's preparatory work were presented in the first meeting of the Financial Services Consumer Group[57] in June 2006. The White Paper and its IA was presented to the group in December 2006. Members of the group were invited to provide the Commission with their views.

Commission services have also actively sought the input of FIN-USE, the Forum of user experts in the area of financial services. Participation to FIN-USE meetings (in December 2005, June 2006, December 2006, June 2007 and July 2007) has aimed to present experts the developments in the asset management area, encourage their contribution to the process and exchange views on the proposals. FIN-USE produced responses to the consultation on the Asset Management expert group report, the Green Paper on investment funds, the market efficiency and alternative investments expert groups' reports and the exposure draft.

(5) IA Steering Group

A steering group was established in February 2006 in the framework of the WPIA. It was re-confirmed early in 2007 to assist in the preparation of this report. Colleagues from Directorates General Competition, Economic and Financial Affairs, Enterprise and Industry,

[57] The Financial Services Consumer Group (FSCG) is a sub-group of the already existing European Consumer Consultative Group (ECCG). The overall objective of the FSCG is to ensure that consumer interests are properly taken into account in EU financial services policy development.

Health and Consumer Protection, Internal Market and Services, Taxation and Customs Union, and the Secretariat General participated in the discussions. The Group met three times in 2007 ahead of the finalisation of this report.

ANNEX 2: Condensed overview of the IA analysis

(Preferred options are marked in bold)

	Impact on:		In favour of? :
Available options	**Investor's protection**	**Efficiency**	**Market integration**
Notification			
Ex-ante verification (of marketing arrangements)	+	-	no
On-going ex-post controls	+/≈	+	yes
Fund mergers			
Information only to disappearing fund's investors	-	+	yes
Information to all investors[1]	+	-	no
Entity pooling			
Allow entity pooling in a broad sense	-	+/-	yes
Allow master-feeder structures	+	+	yes
Management Company Passport (MCP)			
Do nothing[2]	+/-	-	no
MCP for corporate and contractual funds	--	≈	yes
Make the MCP for corporate funds work	-	-	yes
Simplified Prospectus			
KII provided in the form of building blocks	+/-	-	no
KII provided as a single stand-alone document	+	+	yes

[1] Only in certain cases

[2] Even if this option does not seems clearly superior, the analysis has identified important feasibility concerns regarding the other two.

Assessment: '+' = positive; '-' = negative; ≈ = neutral

<u>ANNEX 3: The exposure draft's overview</u>

WORKING DOCUMENT DG MARKT SERVICES

Initial orientations of possible adjustments to UCITS Directive (85/611/EEC)

Overview of key features

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

1. GUIDE TO CONSULTATION PROCESS AND MATERIAL

Initial orientations of possible adjustments to UCITS Directive (85/611/EEC)

The following extensive body of material has been prepared as the basis for public consultation on the form of future possible adjustments to the UCITS Directive. The basic case for introducing these changes was analysed in the Commission White Paper on investment funds and the supporting impact assessment. The White Paper set out the Commission's view that changes to the UCITS Directive were urgently needed:

(6) To remove administrative obstacles and delays to the cross-border marketing of funds through overhaul of the current **UCITS notification procedure**;

(7) To allow fund managers to manage funds which are domiciled in other Member States **(management company passport);**

(8) To facilitate consolidation through **fund mergers**;

(9) To provide for centralised management of assets gathered through local funds by allowing master-feeder **structures**;

(10) To refocus and improve the quality and usefulness of product disclosures provided to retail investors when considering investment in UCITS **(reworking of Simplified Prospectus)**;

(11) To strengthen supervisory powers and **supervisory cooperation to** ensure effective oversight of the increasingly integrated European fund market.

The purpose of the present consultation is to gather feedback on preliminary thinking of DG MARKT services on how to give effect to these objectives. This material is preliminary in nature and without prejudice to any decision that the Commission as a whole may subsequently adopt in respect of these issues. The Commission retains full autonomy and initiative in determining the form and content of its ultimate proposal. The consultation exercise should provide technical and hands-on insight as regards the usefulness and practicability of the envisaged possible adjustments which DG MARKT services and Commission as a whole can take into account when preparing its formal legislative proposal.

The following documents are published as the basis for the consultation:

– The **present overview document** which provides a brief statement of the desired outcome from the changes, a summary presentation of the guiding principles and content of the envisaged adjustments.

– For each of the **envisaged changes**, a detailed presentation of the envisaged possible adjustments is published. This presents the main options considered for realising the stated objective. It undertakes a preliminary analysis of these options from a cost-effectiveness and investor protection perspective. It sets out the working assumptions which inform the envisaged adjustments. It also includes a more detailed presentation of the shape of possible provisions supported by free-format commentary.

In publishing this material, the services of DG MARKT hope to receive considered feedback and views from interested parties in respect of the following

– the design and scope of the preliminary approach: do the envisaged adjustments represent an effective way of achieving the desired result?

– the coherence of the envisaged adjustments with the overall UCITS framework and related legislation;

– the appropriate borderline between high level principles which should be enshrined in the modified UCITS Directive and more detailed measures which should be adopted through implementing legislation;

– any unintended consequences for stakeholders – particularly investors;

– the cost-effectiveness of the envisaged adjustments.

Each working document includes a number of specific questions on which views would be welcome. The basic case for proceeding with the envisaged adjustments has been established in the White Paper and supporting impact assessment. However, respondents may also wish to comment on the case for/against continuing with the envisaged adjustments having had an opportunity to consider the possible concrete measures for giving effect to them.

The **deadline for responses to the initial orientations is 15 June 2007**. Feedback should be sent to:

– e-mail: markt-ucits-exposure-draft@ec.europa.eu.

– post: MARKT G4, Directorate-General for the Internal Market and Services, European Commission, B-1049 Brussels, Belgium.

A public hearing on these initial orientations will be held in Brussels on 26 April 2007.

In the light of reactions to the initial orientations and views expressed at the open hearing, DG MARKT will review its impact assessment and cost-effectiveness analysis, and prepare its draft Commission proposal for legislation. The Commission proposal will be finalised towards the end of 2007/early 2008.

2. INTRODUCTION:

The White Paper on investment funds concluded that there were no grounds, at this stage, to revise the scope of UCITS Directive or overhaul rules on investment policy. Any decision on the need for a wider reshaping of the Directive is deferred pending the results of systematic analysis and preparation. Instead, the short-term focus should be on boosting efficiency and facilitating market-driven restructuring of the investment fund market through targeted amendments to the Directive.

In the White Paper, the Commission undertook to prepare a set of targeted modifications to the UCITS Directive to: (1). Remove delays and administrative obstacles to placing funds on other EU markets; (2). Permit fund mergers; (3). Allow pooled management of assets gathered by different funds; (4). Enable fund managers to manage funds in other Member States; (5). Simplify and improve product disclosures and (6). Strengthen supervisory cooperation mechanisms.

The first 4 sets of adjustment should enable fund managers and other actors to better exploit business opportunities across the single market. Fund managers will be able to restructure their fund complexes (via mergers and pooling), and export their funds and their services more easily. In the case of the Simplified Prospectus, the objective is to refocus and scale back product disclosures so that they are more relevant and meaningful for investors.

DG MARKT services' preparatory work is based on extensive preparation and lengthy consultation of all stakeholders. This includes responses to the Green and White Papers (2005, 2006), the work of the expert group on market efficiency (2006); two open hearings (2005, 2006), workshops, studies, ad hoc meetings with industry, regulators and investors, as well as ad hoc fact finding missions.

DG MARKT services believe that this work can provide the basis for extensive use of relevant new single market freedoms. However, strong investor protection safeguards are foreseen to ensure continued smooth functioning and sustained investor confidence in UCITS funds. DG MARKT services also contemplate stronger provisions on cross-border enforcement and cooperation among regulators to limit the risk that cross-border operations or structures operate to the detriment of investor or markets.

3. THE FUND PASSPORT (NOTIFICATION PROCEDURE):

Strategic objective: Ensure the smooth functioning of the product passport by eliminating administrative obstacles, delays and uncertainty to the marketing of UCITS in host Member States.

3.1 Why should the cross-border pass-porting procedure be reviewed?

Procedures for cross-border marketing are cumbersome, costly and subject to undue supervisory interference. Directive deadlines for completing review of fund notifications have frequently been exceeded. Difficulties have also taken the form of intrusive checks of the UCITS during the notification procedure, additional information requirements or requests to modify documentation or certain fund features (e.g. name/denomination of fund). These difficulties undermine the effectiveness and credibility of the fund passport.

The types of control currently undertaken by host competent authorities do not materially add to the protection of investors or the achievement of other policy objectives. The soundness of the product stems from the compliance of the fund and its manager with the requirements of the Directive, as already certified by the home country authorities. Protracted delays and administrative impediments associated with the current notification procedure destroy value and impose significant opportunity costs.

DG MARKT services envisage a complete overhaul of the notification procedure. This should significantly reduce delays and transform the procedure into a straightforward regulator-to-regulator filing. Under the modified procedure, a host Member State would have no ex ante grounds on which to prevent a UCITS authorised in another Member State from being marketed on its territory. The new procedure would rely heavily on a regulator-to-regulator approach, as in the Prospectus Directive. The UCITS would submit a defined set of documents to its home authority. The latter would be responsible for verifying completeness of this information, certifying that the UCITS is duly authorised and transmitting the specified information to relevant host Member State counterparts. Information covered by the previous 'marketing arrangements' document would now be subsumed in a notification letter. The content and form of local marketing information would be subject to harmonisation at level 2. The right to place UCITS on the market of a host Member State would become effective 3 days after transmission of required documents by the authorities of the UCITS home Member State to those of the host Member State.

3.2 Initial orientations for work on cross-border fund notifications:

1. In the event that a fund manager wishes to market units of its UCITS in another Member State, it should be required to submit a set of relevant information and documents to its home competent authorities. This set of information should include the notification letter with the description of arrangements for marketing (cf. section 3 below).

2. The documentation to be filed should include a translation of key investor information (cf. section on envisaged new approach on simplified prospectus/ product disclosure) into the local language of the target host Member States. These translations should be prepared under the responsibility of the UCITS. Other documents which should be filed for the purposes of notification (prospectus, rules of the fund or instruments of incorporation, annual report) could be provided in the

local language of the target host Member States or a language whose use is customary in the sphere of international finance. This language regime for UCITS notification is modelled on the approach laid down in the Prospectus Directive.

3. The notification letter should provide, inter alia, details relating to local subscription and redemption facilities for local unit-holders, paying agent facilities, facilities for distribution of obligatory disclosures to investors, general information about proposed distribution channels and a contact point where list of distributors can be obtained. This letter should be produced in the language common in the sphere of international finance. Envisaged adjustments would provide for the adoption of detailed implementing legislation to harmonise its scope and form.

4. The authorities of a home Member State should verify that no document is missing before transmitting it to the host authorities. They should enclose in the information package to be sent to the host Member State the attestation that the fund is duly authorised as a UCITS and obligatory disclosure documents (documents already filed with authorities of UCITS home Member State according to its national procedures including prospectus, fund rules or instruments of incorporation, key investor information on product, financial reports).

5. The fund manager could begin the marketing of the UCITS in the host Member State three days after the transmission of the notification by the home authorities.

6. The authorities of a host Member State would have no grounds to ex ante oppose the marketing of duly authorised UCITS in the host Member State. They could check and enforce compliance with applicable national rules on an ongoing basis. The Directive would be modified to confer on host authorities the power to intervene and suspend marketing of a UCITS under certain circumstances. In particular the host Member State competent authorities would be able to invoke emergency powers in the event of clear and demonstrable ground that a UCITS domiciled in another Member State and marketing its units within its territory is in breach of the Directive, and a potential source of investor detriment. The use of these emergency powers would be subject to necessary checks and balances and review by the European Commission (see Section 8 on supervisory powers/cooperation).

7. Any concerns on the part of host country authorities relating to compliance of proposed organisation of advertising or distribution methods with non-harmonised provisions of national law should not constitute a reason to refuse ex ante the right to place the UCITS on the host country market.

4. FUND MERGERS:

Strategic objective: Lay down clear and common requirements and procedures for funds wishing to merge, so as to ensure effective protection of the rights of unit-holders in the merging/dissolving fund(s) and remove any regulatory grounds for competent authorities to object to the proposed merger besides the fulfilment of such requirements and procedures.

4.1 Why should the UCITS Directive provide for mergers of UCITS funds?

54% of European funds manage less than € 50 million of assets. The average European fund size is less than one fifth of that of an American fund. The cost of running and selling these micro-funds is significantly higher than for larger funds. Recent research found that, in a leading European fund domicile, the average TER of a fund with assets under US $ 5 million was more than double that of a fund with over US $ 250 million. Annual scale savings of up to 6 billion€ have identified by other studies in this area.

In order to facilitate the rationalisation of the fund landscape and to foster economies of scale the exposure draft includes provisions to create a framework for fund mergers.

4.2 Initial orientations for work on fund mergers:

1. Scope: The new regime would require Member States to provide for the possibility to merge/amalgamate two UCITS funds (or investment compartments thereof) through three typical methods of merger/amalgamation ((i) merger by way absorption or (ii) by creation of a new fund, which are techniques mainly used in civil law countries; or (iii) merger by way of a scheme of amalgamation, which is widely used in common law jurisdictions). Other national techniques used for mergers between funds remain untouched by the proposal and would remain valid in a domestic context.

2. Coverage of cross-border and domestic mergers: it is considered preferable not to limit the scope of the envisaged mergers provisions to mergers of UCITS established in different Member States. Given the increasingly cross-border investor base of many UCITS, a merger between two widely pass-ported funds domiciled in a single Member State may have implications for a large population of investors outside that country. Consequently, DG MARKT foresees applying the envisaged measures and related investor safeguards to both cross-border and domestic mergers.

3. Both the merging/dissolving and receiving fund should be authorised as UCITS before the merger can proceed. In addition, the receiving fund must be notified for marketing in each Member State where the merging/dissolving fund was notified.

4. There would be no requirement/restriction as regards comparability or similarity of the investment policies of the merging/dissolving and receiving fund.

5. Regulatory approval: The envisaged provisions foresee that the competent authorities of the merging/dissolving fund(s) would have to give their approval before the merger could be presented to unit-holders (including for a vote where this is required under national law). The competent authorities could only refuse this approval in the case of non-compliance with the envisaged measures. They should grant

authorisation within 15 working days of submission of a complete file by the merging/dissolving fund(s).

6. The competent authorities of the receiving fund would not be required to approve the merger and could not veto the operation. Fund mergers are expected to have less significant consequences for the unit-holders of the receiving fund (principal risk would be dilution of fund performance through increased transaction costs associated with portfolio rebalancing: this economic impact can be managed and monitored in other ways, in particular through adequate disclosure to unit-holders by the receiving fund and the latter's right to exit the fund free of charge).

7. The competent authorities of the merging/dissolving fund(s) would receive the common draft terms of the merger, the envisaged disclosure to unit-holders of the merging/dissolving fund, the written approval of the depositary of the merging/dissolving fund and a draft report of an independent auditor, as a basis on which to grant their approval. The depositary should ensure that the terms of the merger are in conformity with the law; the independent auditor should draw up a valuation report.

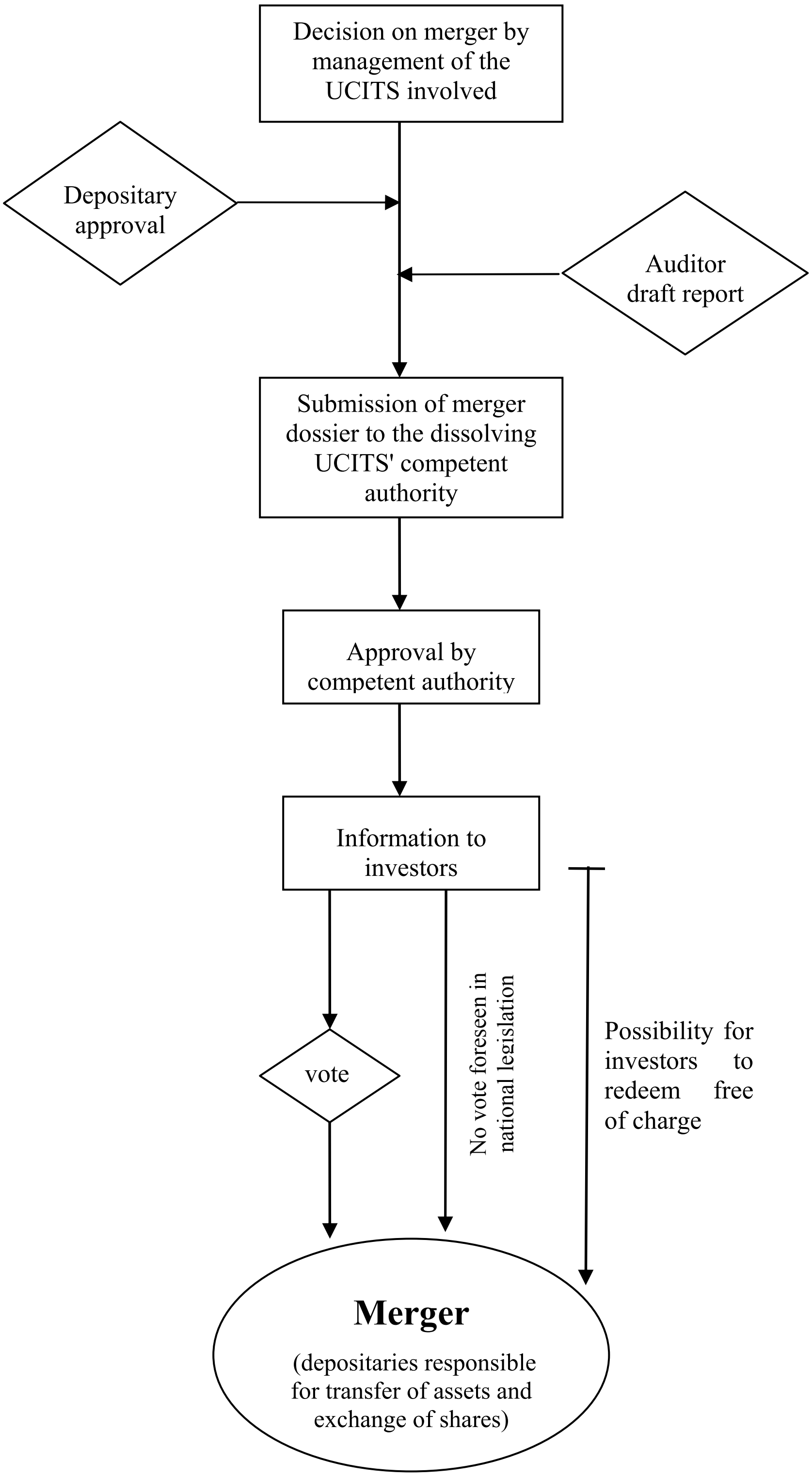
8. Investor information: Investors of the merging/dissolving fund would have the right to receive all relevant information regarding the proposed merger in order to allow them to take an informed decision on the impact of the proposed merger on their individual situation. In certain cases, investors of the receiving fund would also be entitled to receive information about the merger.

9. Investor voting rights: Whether or not investors have the right to vote on the proposed merger would be determined by reference to national law. Where such a vote is provided, it is envisaged to impose a maximum limit on the percentage of votes in favour required (i.e. maximum 75% of the votes cast) in order to prevent excessively demanding voting thresholds from impeding merger completion.

10. Investors would have the possibility to exit the merging/dissolving fund without having to bear redemption or any other type of charges prior to merger completion/within a fixed period of merger completion. In certain cases, investors of the receiving fund would have the same right.

11. Legal, advisory or administrative costs related to the preparation and completion of the merger should not be borne, directly or indirectly by unit-holders.

Diagram: Main steps of the possible merger procedure



5. ASSET POOLING/MASTER-FEEDER STRUCTURES:

Strategic objective: Allow several funds (feeder funds) to pool their assets in a single fund (master fund).

5.1 Why should the UCITS Directive provide for asset pooling?

Proliferation of funds of a small size creates a heavy burden on the fund industry and ultimately investors. Economies of scale are not realised and inefficiencies are passed on to investors. Increasing fund size through mergers is not the only route to achieve economies of scale. Nor is it necessarily the preferred route for fund managers who wish to adapt fund features to local investor preferences (e.g. charging structure). Asset pooling may provide a more appropriate solution. However, fund pooling is currently ruled out by the Directive's diversification rules. Master-feeder structures should allow the following benefits to be realised:

- Economies of scale (especially for small funds with high charges);
- Reduction of charges or better performance for the investor as a result of scale savings;
- Centralisation of core investment management in a single high-performing team (either within the same financial group or among different financial groups ("white labelling"));
- Allowing a financial group to commingle similar funds designed for different types of investors (institutional or retail) and with different fee structures in one entity
- Local presence of the feeder funds providing advantages in terms of servicing client needs, and greater tax-efficiency for the end-investor;
- Two merging financial groups may pool similar funds of both groups in one master fund (and thereby reduce management costs) while preserving the different fund labels;
- Complementary economies of scale alternative to fund mergers.

DG MARKT services have focussed on traditional master-feeder structures. The possibility for a feeder to invest into several masters has been examined but rejected for the following reasons. There is limited practical experience with and demand for that approach. Supervision would become more complex and the prevention of operational risks or possible investment policy breaches more difficult. Such a regime would also be hard to distinguish for legal and supervisory purposes from the existing UCITS 'fund of funds' regime. DG MARKT services have also decided not to pursue further the technique of virtual pooling at this stage. Further research has highlighted potentially important cross-liability and other investor protection concerns. This technique is not widely used – and there are supervisory concerns about its application in cross-border contexts.

5.2 Initial orientations for work on master-feeder structures:

1. While the general UCITS prohibition on funds investing solely in another fund would remain, a special regime should be created for master-feeder structures complying with a new set of requirements. The competent authorities should not refuse authorisation to any proposed master-feeder structure meeting these requirements – including situations where the master or one or more feeders is located in another Member State.

2. The feeder fund should invest almost all (at least 85%) of its assets into a single master fund. The investment of a feeder fund in more than one master is prohibited. Both funds should consequently have the same/near-identical investment policies.

3. The feeder fund would have no/limited investment policy role of its own. It would have some limited possibility to use derivatives to modify fund performance with respect to the master fund or to hedge currency risks. It has some power to use cash to satisfy redemptions or meet other requirements.

4. Both master and feeder are UCITS. Both master and feeder must be fully compliant with all provisions of the UCITS Directive – as regards the provisions governing risk management controls, governance structures, appointment of depositaries etc. It would be possible for master and feeder UCITS to appoint the same management board/trustees, and employ the same management company (including on the basis of the management company passport), depositary (where domiciled in same jurisdiction) and auditor.

5. Provided the envisaged provisions are complied with, the investment of a feeder into a master would have to be permitted by competent authorities.

6. The competent authorities should allow existing UCITS to be converted into a feeder UCITS – subject to requirements to inform investors of the pending change in investment policy and offering them the right to redeem free of charge.

7. The investment of a feeder into a master would not affect the obligations, responsibility and liability of the feeder, or its management company/depositary. In particular, the feeder would need to comply with its obligations vis-à-vis its investors.

8. Information to the feeder's investors should clearly explain the implications of investing into the master from both an investment policy and a fees point of view. Disclosures about feeder investment policy and costs should be harmonised as part of the work on key information disclosures (see section 7 on simplified prospectus/investor disclosures).

9. The master fund would only need to be authorised as a normal UCITS: no specific authorisation is required to enable it to assume the role of master fund.

10. The master can receive assets from non-UCITS asset gathering vehicles, institutional or individual investors: these non-UCITS investors in the master fund would not be subject to any harmonised requirements under the UCITS Directive.

11. Regulatory co-operation: The competent authorities of the master should communicate without delay any decision or measure taken with regards to the master to each of the feeders' competent authorities (as that may have an impact on the feeder).

6. THE MANAGEMENT COMPANY PASSPORT:

Strategic objective: to allow fund managers to manage funds (of either contractual or corporate type) domiciled in another Member State, without generating fiscal or supervisory uncertainty which might undermine the effective oversight or tax-efficiency of the management company/fund chain.

6.1 Why should the UCITS Directive provide for an effective management company passport?

Currently, management groups must establish a fully functional management company in each country where they domicile their funds. This considerably adds cost and hinders specialisation gains. The White Paper impact assessment estimated savings of € 381 to €762 million/year if each asset management group would be allowed to operate from only one location.

The White Paper and supporting impact assessment concluded that the management company passport was a worthwhile objective, and that the Directive should be amended to that end. The White Paper and impact assessment highlighted the need to give further consideration to definition of the scope of the management company passport. In particular, should the management company be allowed to provide the full range of collective portfolio management services on a remote basis or should some functions be considered as an integral part of the fund administration/operation? Advocates of the first approach argue that only the right to passport the full range of collective portfolio management activities would allow full exploitation of the benefits of the single market. However, it has also been observed that such an approach could empty the fund domicile of all substance. This could have detrimental consequences on two counts: 1). It could undermine the capacity of the fund supervisor and depositary to assume certain responsibilities with respect to the administration and operation of the fund; 2). It could lead to the tax authorities of the management company domiciles claiming jurisdiction over the income and revenues of the fund, in addition to taxation in the fund domicile itself.

In the exposure draft, DG MARKT services seek to provide clear and operational tests to identify the respective domiciles of the management company and of the fund in cases where the management company passport is employed. Without that clarity, the jurisdictional uncertainty which has sabotaged previous attempts to introduce a management company passport would persist.

DG MARKT services believe that the envisaged approach would also limit the danger of overlapping tax jurisdictions, i.e. of the fund and its management being both taxed in their respective domiciles. This risk arises only in respect of non-fiscally transparent funds (some contractual funds, trusts and partnerships): funds of a corporate type and many contractual funds from a wide range of jurisdictions would not be subject to the risk of competing tax claims. Where a residual risk remains, it would be for the different national tax authorities to align their taxation policy with the regulatory approach presented below. Should they fail to do so, fund managers in their jurisdiction would not be able to manage some types (of fiscally non-transparent) structure in other Member States. It then falls to each Member State to ensure that its tax policy does not deprive its fund management industry of the opportunities offered by the management company passport. Experience from related sectors (e.g. investment manager exemption in UK for overseas non-transparent structures) demonstrates that tax authorities can be responsive to these considerations.

6.2 Initial orientations for management company passport:

1. The right for the fund manager to manage funds of corporate and contractual type which are domiciled in other Member States would be clearly enshrined. The Directive would also provide for the corresponding right for a UCITS to appoint/designate a management company in another Member State.

2. Clear tests would be introduced to determine the domicile of the management company and of the fund. Clear tests to determine jurisdiction would be necessary to avoid uncertainty over the relevant tax or regulatory jurisdictions. For the same reasons, the tests should also ensure that there is 'substance' in the fund domicile. Fund domicile would be determined by reference to the country under whose laws the fund is constituted. It would also be stipulated that the shareholder register and that reporting of valuations should be maintained/completed in this country.

3. UCITS management companies would be allowed to undertake the full range of collective portfolio management services in respect of funds domiciled in other Member States. No changes are envisaged to the list of functions that are covered by collective portfolio management (apart from decision to clarify that this list is exhaustive).

4. However, where a management company manages a fund domiciled in another Member State via the freedom to provide services, it should ensure that performance of activities related to maintenance of shareholder register and/or completion/filing of fund valuation reports actually/physically take place in the Member State of the fund, and subject to direct reporting to the local competent authorities. It could not perform these functions on a remote basis. However, it could undertake these activities through branching (i.e. through the exercise of the freedom of establishment under the management company passport) or delegation arrangements.

5. The depositary would be domiciled in the Member State where the UCITS is located, as is currently the case.

6. Management companies would be subject to a notification procedure when wishing to managing funds in another Member State (on a remote basis or via branches). The management company home competent authorities should remain exclusively responsible for those services provided on a remote basis[58]. This procedure would be distinct from and not cumulated with the separate procedure for marketing UCITS in another Member State.

7. The provisions governing co-operation between regulators would be reinforced to underpin the effective and seamless oversight of situations where the fund and its manager are located in different Member States. The envisaged adjustments would provide for mechanism for competent authorities to carry out on-the-spot verifications in the other Member State; to enumerate strictly any grounds to refuse cooperation; and to stipulate conditions for competent authorities to take emergency measures in the event of demonstrable concerns.

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[58] With the exception of the rules of conduct applicable to individual portfolio management, investment advice and custody when performed by the management company via a branch, where the Directive confers certain powers to the host Member State (article 6b(3) and 6c(3)).

7. SIMPLIFIED PROSPECTUS/PRODUCT DISCLOSURES:

Strategic objective: Ensure that product disclosures made by fund managers provide relevant and meaningful information to potential investors; reconfigure these disclosures so that they can be used in the different sales channels through which investors buy funds; remove unnecessary legal or regulatory information which create information overload and excess compliance cost.

7.1 Why does the Simplified Prospectus need to be reviewed?

The Simplified Prospectus was meant to provide investors with concise and understandable information about the investment policy, risks and associated charges of a fund. However, it has suffered from national gold-plating and divergent implementation. The result is a lengthy user-unfriendly document that is a source of costs to the industry and of limited utility to investors.

The exposure draft introduces a completely new approach. The Simplified Prospectus is now referred to as "key investor information" - not necessarily to be embodied in a specific document. Level 1 provides for principles only. Further details on content and format are to be decided at Level 2, hence Schedule C of the current Directive (contents of the SP) is deleted.

The approach seeks to adapt product disclosures to take account of the different means through which UCITS are sold to end investors – direct sales (which accounts for only a small fraction of sales), intermediated sales, wrapping or structuring of products in other wrappers. The envisaged measures would require fund managers to make available information concerning their product. However, a joined-up approach is needed whereby this information would be used in a timely and effective way by the intermediaries which sell the bulk of UCITS or other institutions which integrate UCITS into hybrid products (unit-linked life insurance). This would require complementary work on 'point of sale' disclosures outside the framework of the UCITS Directive to ensure that these disclosures are effectively used by banks/investment advisors which sell UCITS; and to extend comparable disclosure obligations to intermediaries selling UCITS wrapped in other products (insurance contracts, tax wrappers, individual savings accounts).

7.2 Initial orientations for work on Simplified Prospectus/key investor disclosures:

1. The envisaged adjustments should distinguish clearly between prospectus, annual/semi-annual reports (these would continue to be produced and made available on request as at present), and “key investor information” disclosures which should be provided to potential retail investors prior to purchasing units in a fund.

2. The key investor information disclosures should be fair, clear and not misleading. Key investor information should be consistent with the relevant parts of the (full) prospectus. Liability issues should be made clear.

3. The key investor information should define the product information which fund managers must make available, free of charge. This would include information about costs relating to the purchase of units, risks and other essential characteristics which would have an important bearing on the investment. The information to be provided would be confined to those disclosures which are meaningful and useful to the

potential investor. Fund would not be held responsible for disclosure of advisory or sales related fees which are charged separately from the product. It should be for intermediaries to disclose costs or fees arising from their role in the sales/advisory process.

4. The key investor information should also define the practical information that should be conveyed to investors to enable them to adequately exercise their rights. Some information points could differ according to the domicile of the investor in certain well-defined cases (subscription/redemption facilities, tax treatment).

5. The envisaged adjustments would not prescribe the detailed content and form of investor disclosures. Instead, they foresee the adoption of detailed implementing legislation (at level 2) to flesh out the guiding principles. The proposed approach envisages particular attention at level 2 to the disclosures that should be provided where the fund manager is issuing units of UCITS with different sub-funds or share classes, funds of funds, master or feeder units.

6. Product information should not be altered when UCITS are marketed in another Member State (under the notification mechanism provided for in Article 46 of the UCITS Directive). Only translations into the local language of the home Member State should be allowed.

7. The envisaged adjustments would seek to clarify the obligations of the fund manager (for the product) when funds are sold through independent advisors or intermediaries. However, the envisaged adjustments to the UCITS Directive should not be the means through which direct obligations are imposed on investment firms, insurance brokers or other non-UCITS entities to make effective use of mandatory fund disclosures. While attention must be given to how authorised entities use this information, the UCITS Directive does not regulate these actors. Regulation of how this information is used at the point of sale is better addressed in the relevant intermediary regulation (e.g. MiFID, Insurance Mediation Directive).

8. The envisaged adjustments would impose a clear obligation on fund managers to make the relevant disclosures available in appropriate form to other parties/intermediaries who may execute orders (i.e. sell UCITS) or issue recommendations on UCITS (i.e. advice on UCITS), or integrate UCITS into another product/wrapper (e.g. insurance contract).

9. The envisaged adjustments should consider the different nature of investors and provide for a possible waiver of the required key investor information disclosures for UCITS taking account of the professional nature of investors.

8. SUPERVISORY COOPERATION:

The envisaged possible adjustments to the UCITS Directive accentuate the need for enhanced cooperation framework between authorities. These adjustments could facilitate growth in cross-border fund sales and the organisation of fund complexes on a cross-border basis. These transactions and operations should be undertaken in a way that supports high levels of investor protection, supervisory confidence and the smooth functioning of the UCITS market. To this end, the current UCITS provisions on supervisory powers and supervisory cooperation should be strengthened. This could be done largely by aligning the relevant UCITS provisions on comparable provisions in the MiFID Directive and other recent securities legislation.

Accordingly, the existing provisions of the UCITS Directive dealing with these issues should be strengthened to:

1. ensure equivalence of powers for competent authorities;

2. develop existing mechanisms relating to exchange of information;

3. create arrangements which allow competent authorities of a Member State to, in the exercise of their responsibilities under the Directive, carry out on the spot verification of information and investigation on the territory of another Member State, or have them carried out by the competent authorities of another Member State/ third parties.

In addition, the envisaged adjustments recognise the possibility for host competent authorities to intervene in the event of demonstrable and material detriment to local investors or market conditions resulting from a breach of provisions of the Directive by UCITS or management companies from another Member State. The right of the host authority should be a 'last resort' in the event of failure of the home authority of the UCITS or management company to take effective and timely corrective action. The exercise of such right would be subject to notification to and review by relevant committee structures and/or the European Commission.

ANNEX 4: The Lamfalussy process

The new regulatory structure of the so-called Lamfalussy process has been initiated by the Stockholm European Council Resolution of 23 March 2001 on "more effective securities market regulation". The Lamfalussy process is based around the four-level regulatory approach recommended by the Committee of Wise Men on the Regulation of European Securities Markets, chaired by Baron Alexandre Lamfalussy[59].

The Lamfalussy process was designed to make Community legislation on securities markets more flexible, so that it can be agreed and adapted more quickly in response to innovation and technological change in financial markets; to allow the Institutions to benefit from the technical and regulatory expertise of European securities regulators and from better involvement of external stakeholders; and to focus more on even implementation and enforcement of Community law in the Member States.

One of the key innovations of the Lamfalussy process is the creation of two Committees to advise the Commission on Level 2 implementing measures – the **European Securities Committee (ESC)** representing the Member States and functioning as a so-called 'regulatory committee' under the Comitology arrangements[60] – and the **Committee of European Securities Regulators (CESR)**. The two Committees were set up by Decisions of the Commission on 6 June 2001[61]. The ESC acts in its capacity as a regulatory committee, assisting the Commission in the exercise of its delegated executive powers, within the terms defined in the Directives adopted at Level 1.

Transparency is another important feature of the process. The Lamfalussy process has established a rigorous mechanism whereby the Commission seeks, *ex-ante*, the views of market participants and end-users (companies, investors and consumers) by way of early, broad and systematic consultation, with particular regards to Level 1 proposals, but also at Level 2.

As the UCITS Directive has been adopted long before the Lamfalussy process has been put in place, it can not directly take advantage of these procedures. However, some of the structures have been successfully implemented with the 2001 amendments to the Directive.

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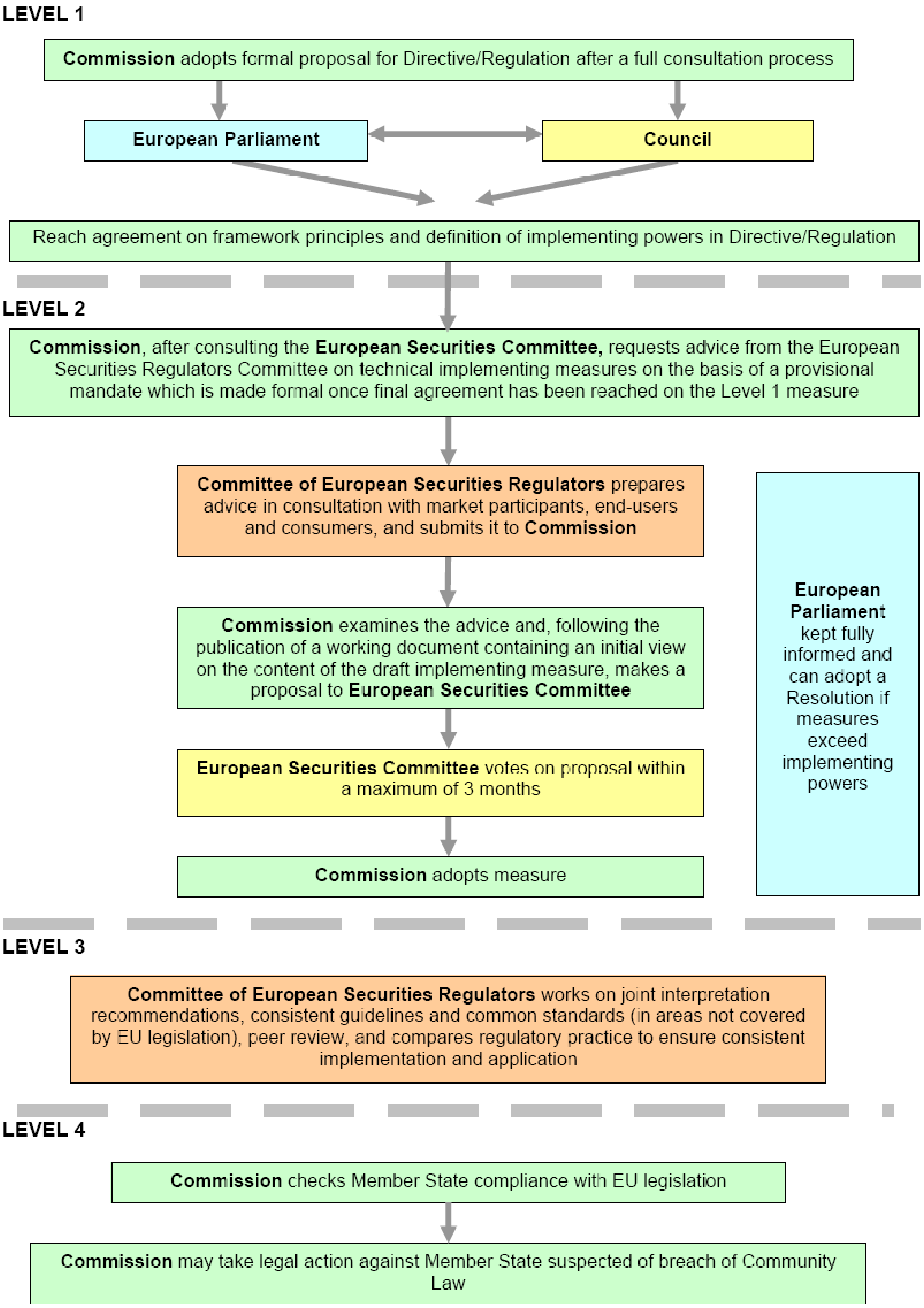
59 The Lamfalussy report, published on 15 February 2001, can be found on the Commission's website: http://europa.eu.int/comm/internal_market/securities/lamfalussy/index_en.htm

60 See Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission, OJ L 184, 17.7.1999, p. 23.

61 See Commission Decision of 6 June 2001 establishing the Committee of European Securities Regulators (2001/527/EC), amended by Commission Decision of 5 November 2003 (2004/7/EC), and Commission Decision of 6 June 2001 establishing the European Securities Committee (2001/528/EC), amended by Commission Decision of 5 November 2003 (2004/8/EC).

- Graph: The four-level regulatory approach under the Lamfalussy process[62]



[62] SEC(2004) 1459; the Level 2 phase will be modified following the entry into force of new comitology arrangements, anticipated for the end 2006/ beginning 2007.

ANNEX 5: List of acronyms

AFG:	Association Française de la Gestion Financière
ALFI:	Association of the Luxembourg Fund Industry
AM:	Asset Management
AMF:	Autorité des Marchés Financiers
AuM:	Assets under management
bn:	billion
CA	Competent Authority/ies
CEIOPS:	Committee of European Insurance and Occupational Pensions Supervisors
CESR:	Committee of European Securities Regulators
CIS:	Collective investment schemes
CPM:	Collective portfolio management
EFAMA:	European Fund and Asset Management Association, formerly FEFSI
FEFSI:	Fédération Européenne des Fonds et Sociétés d´Investissement
ESC:	European Securities Committee
EVCA:	European Private Equity and Venture Capital Association
FEAM:	Forum of European Asset Managers
FIN-USE*:*	Forum of user experts in the area of financial services
FSA:	Financial Services Authority (UK)
FSAP:	Financial Services Action Plan
GDP:	Gross Domestic Product
IA:	Impact Assessment
ICI:	Investment Company Institute (US)
IFA:	Independent Financial Advisors
IMA:	Investment Management Association
IOSCO:	International Organization of Securities Commissions
LDI:	Liability-driven investment
MC:	Management company
MiFID:	Markets in Financial Instruments Directive 2004/39/EC
MS:	Member State
REF:	Real estate funds
TER:	Total expense ratio
TNA:	Total net assets
UCITS:	Undertakings for collective investment in transferable securities
UCITS III:	Directive with 2001 amendments
WPIA	White Paper Impact Assessment

ANNEX 6: References

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Notification

Problem description

The UCITS Directive introduced in 1985 the first financial product passport. Investment funds authorised in accordance with the Directive requirements could be sold in other MS. A notification procedure was however foreseen. This requires UCITS to send the regulator of the country targeted (host MS) a file including the planned marketing arrangements and a series of fund related documents, such as the fund rules, prospectuses, authorisation certificate… Marketing in the host MS can start two months after this notification; unless the host MS regulator considers that the marketing arrangements do not comply with national rules[63].

The idea of the fund passport relies on the mutual trust between national regulators that recognise the UCITS authorisation given by another MS regulator. Having the fund notified instead of authorised in every MS where the fund provider wishes to market it was aimed to create a single market for funds that would considerably reduce costs and delays in bringing new funds to the public across the EU. Investor protection was guaranteed at different levels. First, through the authorisation given by the fund home MS regulator. Then, by the host MS regulators who verified the compliance of marketing arrangements with applicable national rules.

However, host MS regulators have adopted different approaches in implementing the notification provisions. Some request additional documents to those listed in the Directive, impose additional translation requirements or ask for changes to documents such as the simplified prospectus. Some cases have also been reported in which regulators verified or questioned the authorisation given in another MS. As a result, the UCITS notification has turned in many cases into a kind of second authorisation, rendering pan-European distribution of funds a time-consuming, cumbersome and costly task[64].

According to a survey carried out in 2006 for the European Commission[65], notification costs in terms of internal resources and use of external lawyers are often limited. It accounts for less than 0.25 basis points[66] of the total fund costs for the largest providers. Despite this small figure, regulatory processes were nonetheless one of the key areas where fund managers expressed most concern in the interviews conducted. Fund managers regarded the differences between MS in respect of notification as one area where cost savings could be achieved

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63 Marketing arrangements need to comply with national rules governing issues falling outside the scope of the Directive and issues for which national rules apply under the UCITS Directive. Host Member State verification covers i.a. distribution infrastructure, marketing techniques and channels, facilities for making payments, repurchase, redemption of units of UCITS, facilities for distribution of compulsory information to investors. The scope of host Member States' residual powers has been discussed in the Commission Interpretative Communication on respective powers retained by the Home and the Host Member State in the marketing of UCITS pursuant to section VIII of the UCITS Directive, published on 19th March 2007 (COM(2007) 112 final.

64 A practical example showing to which extend MS regulators see the notification procedure as a re-authorisation is the level of notification fees that equal authorisation ones in a number of MS. Time-wise, in some cases, the notification procedure even takes longer than the authorisation one. (Please see European Commission 2006e (CRA study))

65 CRA study

66 Measure used in financial services. 100 basis points is equivalent to 1%.

relatively easily and rapidly. A report in 2005 by EFAMA/IMA[67] estimated direct annual costs for the fund industry for maintaining notification of about €25 million (in addition to more than €20 million for the initial notification).

However, many consider that even more important than those savings are the business opportunities missed. For newly developed products there is a race to the market in order to benefit from the first mover advantage resulting from the early recognition of the product by distributors and investors. Time-to-market is key, not only vis-à-vis other funds but also vis-à-vis competing products. Numerous voices during the exposure draft's open hearing (April 2007) and consultation highlighted 'level playing field' concerns. Notification of other similar financial products, such as structured notes, certificates and shares of closed-ended funds, covered by the Prospectus Directive is done within three days. This difference might encourage financial services providers to focus their offer more on these products. However, these products are often subject to less restrictive information and other investor protection requirements. There is therefore a risk that investor protection would be undermined.

Delays in notification are regarded as having a severe impact on competition. It results in fund promoters being frustrated and retreating from the respective (host) market (notably small ones). This is a cost in terms of dynamic competition with the impact of competitive forces being reduced. This translates in higher costs and a more reduced fund choice for the investor.

Host regulators' attitudes are often seemed as a disproportionate way to protect investors. Only the incorrect application of the UCITS Directive in the authorisation process by the home Member State could justify any need for "double-checking". That said, even if that were the case, infringement procedures seem a more appropriate way to deal with a mis-implementation of the Directive.

However, the current situation is not only due to over-zealous host authorities. It is also the result of unclear or incomplete provisions regarding important aspects such as the residual powers of the host MS regulator or translation requirements. Additionally, in view of new technical means, more could be done to enhance efficiency. Modern transmission methods could be used to considerably reduce delays.

The adoption in June 2006 of CESR guidelines on the notification procedure has been an important step to improve the situation (a summary of its recommendations is provided in the box below). However, without a decisive change of the Directive related provisions, the improvements risk to remain marginal[68]. Also, the effectiveness of many of those non-binding recommendations would very much benefit from new provisions in the Directive underpinning them.

[67] "A Harmonised, Simplified Approach to UCITS Registration", EFAMA and IMA, April 2005.

[68] e.g. recommendations to speed up the procedure as much as possible may have little effect if the two-month deadline remains in the Directive.

Box : CESR main recommendations

- A standardised notification letter should be prepared. It may be submitted in a language common in the sphere of international finance and by electronic means.
- If marketing arrangements comply with the relevant provisions, the passport needs to be respected.
- The two-month period is to be respected; unless host regulator establishes (reasoned decision) that marketing arrangements don't comply with the relevant provisions. The period starts when the notification file is complete. It should be shortened whenever possible.
- Self-certification by the UCITS (that the submitted versions are the last ones) should be accepted.
- Host regulator can approve the use of languages other than the official one(s).
- Procedure for notification of sub-funds of an umbrella fund may be simplified and shortened.
- The notification file should contain: UCITS attestation, notification letter, fund rules, prospectuses, annual report and marketing arrangements. Changes or updates need to be submitted without delay to the host regulator.
- Regulators to publish overview of non-harmonised national provisions in their websites.

In March 2007, the Commission adopted an implementing Directive clarifying whether certain financial instruments are eligible for inclusion in a UCITS fund's portfolio. At the same time, the Commission also issued guidance (in the form of an Interpretative Communication) on how host country authorities should exercise their limited scrutiny powers when UCITS are notified for sale in their country. In that Communication, the Commission reaffirmed that the fund's home supervisory authority has sole responsibility for monitoring compliance with UCITS rules, and that the notification procedure cannot be used by Member States to challenge authorisation of UCITS granted in another Member State.

These two sets of clarifications aimed to ensure consistency in the authorisation[69] and marketing of UCITS across the EU. However, as announced in the White Paper a more fundamental redesign of the UCITS passport is indispensable. In this respect, the WPIA recommended amending the Directive in order to a) reduce notification delays, b) replace the current procedure by a regulator-to-regulator communication exchange[70] and c) remove legal uncertainties regarding regulators' respective roles and responsibilities.

[69] This should help reducing host regulators' reticence to accept the authorisation given by home regulators.

[70] This communication between authorities follows the example of other more recent financial services Directives. It also aims to avoid that the process is delayed by additional documents or clarifications' requests to the UCITS. Implications on the side of regulators should be limited since communication and information channels between regulators are already in place.

On that basis, the exposure draft published in March 2007 presented a real overhaul of the current notification procedure. It put forward a direct transmission from the home regulator to the host regulator of a (exhaustive) list of documents; allowing marketing 3 days after this transmission. According to the proposal, the authorities of a host MS could not oppose the marketing of duly authorised UCITS in the host Member State. They would check and enforce compliance with applicable national rules on an on-going basis. They could, however, invoke emergency powers in certain cases. Finally, a new language regime was suggested in order to reduce the burden of producing investors' disclosures: only the key investor information would need to be translated into the host investor's language.

Responses to the Exposure Draft consultation

General principles: The revamped notification procedure proposed in the exposure draft was considered a significant step forward (also by non-industry stakeholders). Some respondents were however concerned about the elimination of the host MS regulator ex-ante controls. They considered that this may be detrimental to investor protection. On the other hand, others opined that the risk is limited since distribution was generally done by authorised actors and regulated by MiFID.

Procedure length: Although most respondents welcome the time reduction of the proposed procedure, a few questioned the need for the three-day delay following transmission of the notification file. Others considered this three day delay as too short. A few asked to provide also a fixed period for the home regulator to check (and transfer) the notification file.

Local marketing rules: Many contributions asked for regulators to publish national rules regarding the non-harmonised issues with which notified funds must comply. Clarifications were also requested regarding the residual powers of the host MS regulator.

Language regime: proposals relating to the translation of documents were very much appreciated by contributors to the consultation. Many anticipated substantial cost savings. Some national authorities and investors' associations however defended the right of the host MS investor to have access to all documents in his/her language (as the investor in the fund's home MS has).

Other procedural proposals: The possibility to use electronic communication means was broadly welcomed.

Objectives

A new notification procedure should properly respond to the different stakeholders' concerns and expectations and thus should:

a) from a single market perspective:

- Facilitate the entry into a national market of foreign UCITS (therefore widening the offer and fostering competition)
- Promote the development of funds raising assets from across the EU (and thus encourage scale savings and specialisation gains)

b) from an industry angle:

- Improve UCITS' time-to-market into other MS (thus, enhancing funds ability to compete with other similar investment products)
- Create the minimum (administrative) burden
- Reduce the costs associated to the procedure

c) from the regulators' point of view:

- Be clear as regards regulators' respective responsibilities

d) as well as, ensure that investors:

- Have access to an enlarged fund offer
- Are adequately protected

Benefits

The main benefits of a new notification procedure would be the following:

	For investors	**For the industry**
Short-term	A greater fund choice	More business opportunities; lower costs
Long-term	Lower costs	More business opportunities; lower costs

Although the short-term costs savings derived from the simplified procedure would most probably not be outstanding, the dynamic effects triggered by an easier access of UCITS to other MS markets will have an important and decisive positive impact. Both industry and investors are to benefit from it. New business opportunities by the industry will be matched by a greater choice for investors. In the long-run, fund providers would be able to pool in a smaller number of funds the assets raised from a number of MS (achieving thus economies of scale). The increased number of funds in national markets should encourage competition and, therefore, lower costs for investors.

Design of the new notification procedure

Preferred choices are presented in bold and italics.

a) (First) notification

Possibilities	Comments
Host regulator checks marketing arrangements before the fund starts marketing in the host MS (ex-ante control) Host regulator checks on an on-going basis marketing arrangements after the fund has started marketing (on-going ex-post control)	Verification of marketing arrangements ex-ante will not change significantly the current situation. This option would need then to be accompanied by a firm time reduction and clear provisions as regards host regulator competences in order to make a difference. On-going ex-post controls would allow to considerably improve funds' time-to-market. This option may however give rise to some investor protection concerns if marketing arrangements do not comply with national rules. On the other hand, some consider that UCITS are generally distributed through regulated intermediaries and there should then be no need for the host regulator to pre-check the fund's marketing arrangements. Giving the complexity of these options a more in-depth analysis (please see the following section) seems therefore necessary.

b) Subsequent notifications

Relevant aspects	Possibilities	Comments
New sub-funds in an umbrella fund[71]	No notification required (unless changes of marketing arrangements) ***Reduced notification requirements*** Normal notification requirements	Even within the same umbrella fund, sub-funds often pursue completely different investment policies. It seems therefore appropriate that new sub-funds would be notified (please see above). On the other hand, part of the information would have already been submitted. A simplified procedure could then be envisaged. It remains however to be decided whether clarification of such details should not be left for Level 2 (Level 1 would then focus on main principles).
New share classes	***No notification required (unless changes of marketing arrangements)*** Reduced notification requirements Normal notification requirements	Creation of new share classes within a fund does not most often substantially change its main characteristics or distribution method. Therefore, requiring notification for the shares of an already notified fund may be seemed as a disproportionate (and onerous) measure. Whether clarification of such details should not be left for Level 2 remains however to be decided.

[71] An umbrella fund is an investment term used to describe a collective investment scheme which is a single legal entity but has several distinct sub-funds which in effect are traded as individual investment funds (definition from http://en.wikipedia.org).

Marketing arrange-ments updates	Home regulator provides host regulator with updates ***UCITS provides host regulator with updates*** Updates are made available in home regulator's website	Since the host regulator will need to check changes to marketing arrangements, simply relaying on its publication in the home regulator's website may (from an investor protection point of view) not be appropriate. On the other hand, introducing a direct UCITS to host regulator transmission will somehow go against the new regulator to regulator approach. However, this would seem the most cost-effective solution (particularly if the host regulator needs clarifications or requires changes to the arrangements)
Other documents updates	Home regulator provides host regulator with updates UCITS provides host regulator with updates ***Updates are made available in home regulator's website/database***	Providing for a regulator to regulator transmission would considerable burden the process for not significant benefits. Introducing a direct UCITS to host regulator transmission will still impose a certain administrative burden on both the UCITS and the host authority. Since those documents don't need to be checked by the host regulator, their posting on the home regulator's website/database may be sufficient. Modalities could be then determined at level 2.

Relevant aspects	**Possibilities**	**Comments**
New funds of the same provider	No notification required (unless changes of marketing arrangements) Reduced notification requirements ***Normal notification requirements***	It can be argued that if marketing arrangements remain the same, new funds would not need to go through a full notification procedure. Notification could serve other purposes though, such as letting host regulators know about the funds sold in their jurisdiction. Besides, the additional benefits of 'reduced' notification requirements appear limited if these still imply providing the host regulator with prospectus, simplified prospectus and annual report (different from a fund to the other) or if notification delays have been (as intended) significantly reduced.

c) Other procedural choices

Relevant aspects	Possibilities	Comments
Transmission delay	Fixed period of time for home regulator to check the notification file ***No deadline is imposed on the Home regulator***	The Prospectus Directive provides for a maximum period of 3 days, after submission by the issuer of the notification file, for the home regulator to transmit it to the host regulator. Imposing a similar deadline would ensure a swift notification procedure and would partly re-level the playing field between UCITS and competing products. It would reduce also uncertainties re. the duration of the procedure. However, it should be noted that there is not a particular interest for the home regulator to unduly delay the transmission[72]. EU level intervention in this respect may then be of little effectiveness and rather unnecessary.
Language regime[73]	All disclosures are translated into local language ***Only the key investor information is translated into local language***	The requirement to translate all obligatory disclosures into a host MS language considerably adds to the industry's administrative burden and leads to delays in the marketing of the fund. It is an important entry barrier into certain markets (particularly small ones) that has important implications on investors' side: additional costs are ultimately passed on to investors; smaller fund ranges are available to them. It is often argued that investors do not make use of most of those documents due to their complexity. Requiring only translation of the 'key investor information'[74] appears then a cost-effective measure to ensure the protection of investors[75] and, at the same time, shorten delays and allow costs savings[76]. It has been argued that in order to enhance investor protection the key investor information should clearly indicate in which language(s) the other fund documents are available. It would then be advisable to give the fund provider the possibility to decide (for commercial reasons) which other documents would be translated[77].

72 A 'healthy competition' among CA (as the observed in the recent past with regards to the authorisation procedure) could be expected. Systematic long delays could encourage fund promoters to base their new funds in other jurisdictions.

73 The option 'no translation at all' is ruled out for evident investor protection reasons.

74 This is consistent with the approach followed by the Prospectus Directive (which covers other investment products that compete directly with UCITS funds).

75 'Key Investor Information' is aimed to provide all the information the investor needs in order to make an informed decision as regards to the fund offered to him/her. Subsequent monitoring of his/her investment is facilitated by the fact that UCITS have the obligation to update the KII.

76 A respondent to the exposure draft consultation estimated savings amounting to a third of its total notification costs if translation of the full prospectus was not required anymore.

77 It has also been proposed to provide for a delayed translation of such other fund documents or for a translation upon request only.

Relevant aspects	Possibilities	Comments
Local marketing rules	Full harmonisation ***Different local rules apply (status quo)***	A full harmonisation of local marketing rules would reduce uncertainty and costs, as well as, ensure an equivalent level of investor protection in different MS. However, achieving this harmonisation would be a real challenge. The existence of different rules often reflects cultural or investor protection preferences. Efforts may then prove to be fruitless. Besides, the UCITS Directive may not be the most adequate framework for this harmonisation (MiFID could be a more appropriate one).
Distribu-tion of disclosures in host MS	Full harmonisation ***Host MS rules apply*** Home MS rules apply	According to the current art. 47 of the Directive, the distribution of disclosures follows home MS rules. These may differ from those of the host MS. A full harmonisation of disclosures distribution methods would reduce uncertainty and costs as well as ensure an equivalent level of investor protection in different MS. However, to achieve this harmonisation may prove difficult. The existence of different methods often responds to national cultural or investor protection preferences. However, if different distribution rules for disclosures remain, it seems more appropriate, for the sake of investor protection, that the rules with which host investors are more familiar apply.

Impacts analysis

The tables above provide an overview of the main recommended features for a new notification procedure. Many of the choices are uncontroversial. However, as shown during the exposure draft consultation, the moment (and time available for it) in which the host MS regulator will be able to check the fund's marketing arrangements is considered by many as key in order to ensure investor protection. Thus, as indicated above, the following options will be analysed in more detail in this section:

Option 1: Ex-ante control of marketing arrangements

Description: Following transmission (by the home regulator) of the notification file, the host regulators will have 2 weeks to check marketing arrangements. Home regulator will inform the UCITS of the date of transmission. Problems identified (or clarifications needed) by the host regulator should be communicated to the fund promoter within those 2 weeks. The clock can be stopped only if those arrangements are not in line with national rules (or incomplete). After 2 weeks, the UCITS can start marketing its units in the host MS unless formal refusal has been provided.

Option 2: On-going ex-post control of marketing arrangements

Description: The UCITS can start marketing its units in the host MS immediately after transmission (by the home regulator) of the notification file. Home regulator will inform the UCITS of the date of transmission. The host regulator checks 'ex post' on an on-going basis that marketing is conducted in accordance with national rules.

Option 1: Ex-ante control

Impacts from the point of view of:

a) **Industry**: The resulting situation would most probably differ very little from the current one. The need to check the marketing arrangements may be used to justify current notification fees. Also hiring a local team of consultants to prepare the notification file and to deal with the host regulator may most probably still be required. This is often not a negligible cost. One of the respondents to the exposure draft consultation estimated at some €300,000 their annual legal expenditure related to notification. Also the 2005 EFAMA/IMA report showed examples in which legal costs amounted to some 40% of the total costs of (initial) notification (i.e. some € 8 million). Thus, the expected economic savings of this option are small (if any at all). Uncertainty about UCITS time to market in the host MS would also remain[78]. The notification procedure would then continue to act as an entry barrier to national markets. This may in the medium-term protect the national fund players. However, it will also restraint competition forces and therefore hinder national industry's incentives to pursue economic efficiency.

b) **Investors**: From the point of view of investor protection, the reduction of the time available to the host MS regulator to check marketing arrangements (from the current 2 months to 2 weeks) should not have any negative impact. An important proportion of the sales in a market of foreign funds are done through regulated distributors. Around 75% of funds are sold through MiFID authorised entities such as banks or investment firms[79]. (The rest is basically sold through insurance providers [covered by the Insurance Mediation Directive] or other nationally regulated entities.*)* The MiFID sets the minimum rules that intermediaries should comply with. From an economic point of view, a burdensome notification procedure restricts the entry into national markets of foreign funds and, thus, reduces the choice available to investors. It also restrains healthy competition forces that could otherwise push prices (fees) down. The additional costs imposed by the procedure would be passed on to investors at the end of the day. It is also argued that UCITS long time-to-market limits industry's ability to exploit financial innovation possibilities and to respond timely to investors' needs. There is therefore the risk that faced with products both more costly and less adapted to their preferences; investors will turn to other similar investment products (generally subject to less strict investor protection obligations). In that case, investor protection could be at risk. This is not a mere theoretical possibility. Regulators and investors start to voice this concern. Concretely, during the exposure draft consultation some consumers' associations highlighted the problem of "unlevelled playing field" between financial products and asked for "consistent standards of investor protection throughout the different investment options available to them"[80]. The Green Paper on Retail Financial Services recognises the need for greater coherence. While this is something that the UCITS Directive cannot address alone[81], Commission services are reflecting on the extent of the potential risks and the need and form of possible measures. A call for evidence on this issue has been launched by Commission services on 26th October 2007.

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78 There exists the risk that the two-week deadline would be abused (and 'stopping-the-clock' could become a normal practice for host regulators in order to be able to check fund documents other than the marketing arrangements).

79 Estimation based on FERI distribution data (end 2006)

80 e.g. FIN-USE response to the exposure draft consultation.

81 Also, the Green Paper concluded that 'it would be a retrograde step for investors if UCITS disclosures were scaled back as a result of regulatory competition'.

c) **Regulators**: Additional resources may be needed on the side of the host regulator to comply with the two-week deadline. (However, in many cases, this could just imply a reallocation of resources from those currently used to check fund documents other than marketing arrangements.) On the other hand, the new role of the home regulator will require new resources. These would, however, not be substantial if its role is limited to checking completeness of the notification file and if transmission is done electronically. Further needs for additional resources are not to be excluded though. Mis-trust between regulators may still require a strengthening of regulators' powers, as well as of cooperation mechanisms. However, this could take place within existing cooperation frameworks and should, therefore, not be exceptionally onerous.

Option 2: Ex-post on-going control

The rationale behind this option lays on the fact that marketing of UCITS generally takes place through regulated intermediaries and, therefore, the justification for pre-checking marketing arrangements is lesser.

The following table provides an overview of the percentage of fund sales taking place through different distribution channels.

Table: Distribution channels (end 2006)

	retail bank	private bank	pension/ insurance wrapper	IFA[1] advised	super-market	direct	fund of funds	institutional	other
Austria	51,5%	31,0%	2,0%	1,0%	0,5%	0,2%	13,3%	0,5%	0%
France	25,9%	11,0%	19,5%	4,0%	0,4%	0,3%	12,7%	26,0%	0,20%
Germany	47,5%	13,4%	18,7%	11,4%	1,0%	0,5%	2,9%	4,5%	0,10%
Italy	63,0%	8,7%	15,2%	10,2%	0,5%	0,2%	1,5%	0,5%	0,20%
Nordic	55,0%	7,0%	27,0%	3,0%	3,0%	1,0%	1,5%	2,4%	0,10%
Spain	64,6%	5,9%	3,0%	4,3%	0,2%	0,0%	11,1%	11,0%	0,00%
UK	8,0%	6,0%	16,2%	50,2%	5,0%	1,0%	1,7%	11,5%	0,40%

Source: FERI data digest 2007; [1] Independent Financial Advisors

Impacts from the point of view of:

a) **Industry**: In the absence of a pre-check of the marketing arrangements, the current € 20 million initial notification costs could be saved[82]. More dynamic effects are also to be expected. The shorter time-to-market for funds will enhance their competitiveness vis-à-vis other investment products. Besides, a more efficient passport could also reduce the need to have different national fund ranges. A single cross-border fund could then pool assets from investors in several MS. This should, in the medium to long-term, promote economies of scale and reduce costs.

82 It has been argued that this would imply more responsibilities (and possibly a higher burden) for distributors. Additional costs for those could then be passed back to the fund promoter through distribution agreements and, at the end of the day, to investors. Nevertheless, most of this additional burden would probably already have been incurred by the implementation of the MiFID.

b) **Investors**: In the short-term, the new procedure will lead to an increase in the number of funds and, thus, allow a better match between investors' needs and preferences and the offer available to them. In the long-term, the increase in the number of funds should foster competition and therefore put pressure on fees. Some investor protection concerns have been expressed during the exposure draft consultation though. It is argued that, in the absence of prior verification by the host regulator, the interest of its country's investors would be endangered[83]. This argument however does not take into consideration that another regulator has already verified the UCITS' compliance with the Directive's provisions. UCITS also need to comply with all host country legislation relating to the fields not covered by the UCITS Directive and ex-ante checks of marketing arrangements is not the only tool available to regulators in this respect. National rules on publicity, misleading information…would still apply. Additionally, the implementation of MiFID will ensure that conflicts of interests or mis-selling risks are reduced[84]. Other on-going initiatives, such as the Simplified Prospectus planned repair work (please see the 'key investor information' fiche) would ensure that investors are better informed and, therefore, allow them to be more critical. Host regulators on-going 'ex-post' checks should also ensure a certain discipline. If a fund promoter does not comply with the applicable local rules of a home Member State, it will risk infringement procedures and penalty payments. Additionally, fund promoters have an interest to avoid such procedures and penalties since these could endanger their image.

c) **Regulators**: The new procedure should not have a significant impact on host regulators' resources. Resources used until now to check marketing arrangements (and other UCITS related documents) will be freed for the new tasks (e.g. 'ex-post' checks). As already indicated, the need for the home regulator to comply with its new obligations should not have a significant impact on its resources. As also explained above, the introduction of greater powers[85] and new cooperation mechanisms should not have a considerable impact either. Additionally, this modus operandi will not be completely at odds with current supervisors' practices. In fact, a number of MS already carry out ex-post checks. Some of them have moved away from ex-ante controls which were considered too burdensome. The publication of guidelines by the regulator appears often as an effective way to help industry players to comply with the rules. (Publication of relevant local rules was also recommended in a number of industry and regulators' responses to the exposure draft consultation)

<u>Other effects</u>

Impact on SMEs: A positive impact on smaller cross-border industry players can be expected under the second option. Burdensome host requirements and practices prevent the access of smaller fund providers to certain national markets. Due to their more limited resources, they are then forced to confine their cross-border expansion to markets of easier access. Option two would thus create greater business opportunities for a larger number of fund providers.

Administrative burden: In addition to the savings in notification fees and legal costs the new notification procedure will have an important impact on the administrative burden borne

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83 Some respondents to the exposure draft consultation stressed that, in the case of breaches of national rules, the regulator's intervention risks taking place once the damage has already be done (please see the responses of the Financial Services Consumer Panel.

84 As shown in the table above, an important percentage of funds distribution (notably through banks) is covered by the MiFID.

85 In particular, emergency powers for the host MS authorities (e.g. when the home MS regulator's measures prove inadequate or when that regulator fails to act) may need to be considered.

currently by the fund industry. The recommendation to limit translation (into the host MS official language) to solely the KII will considerably reduce that burden. While this reduction is difficult to quantify, one of the pan-European players contributing to the consultation on the exposure draft estimated savings of approximately one-third of its notification costs. Other recommendations to further alleviate the administrative burden linked to the notification procedure would be to clearly determine the content of the notification file (and thus rule out host MS' requests for additional information) and to allow for its electronic transmission.

Summary table

	Specific Objectives			Overall Objective
	Investor protection	Efficiency[86] administrative burden	Efficiency[86] sector efficiency	Pro Single Market?
Ex-ante control	+ *(no investor protection risk)*	- *(higher burden)*	- *(higher costs; less business opport.)*	no *(barrier entry to host market)*
Ex-post on-going control	+/≈ *(current protection levels maintained)*	+ *(lower burden)*	+ *(lower costs; more business opport.)*	yes *(will encourage market integration)*

Preferred option

As showed in the above summary table, option 2 (ex-post on-going checks) is a superior solution from an efficiency and single market point of view. It should not be either detrimental to investor protection. As explained above, marketing of UCITS does not take place in a vacuum, national and EU rules exist. Compliance with those is facilitated by the fact that a high proportion of UCITS are marketed to the public through EU or national regulated channels. Therefore, the correct enforcement of the rules set by national law or Directives such as the MiFID appears a more effective way to minimise any potential investor protection risk (than to foreseen systematic ex-ante checks in the UCITS Directive). There remains however a risk that distribution through non-regulated intermediaries/channels would breach relevant rules and cause investor prejudice. However, as shown by the figures in the 'distribution channels' table (this category of intermediaries is included in the percentage displayed in the column 'other'), the likelihood (and magnitude) of this risk should be minimal.

Other (general) considerations

As often highlighted during the exposure draft consultation period, a swift notification procedure will up to a certain extent depend on the on-going work on the simplified prospectus/key investor information. A number of respondents required the Directive to

[86] Administrative burden refers to the costs linked to the production/provision of information that would have not been collected/provided in the absence of a legal obligation. Sector efficiency refers to efficiency gains derived from lower fund production costs, more rationalised processes or the greater flexibility and opportunities offered to industry players.

clarify that the KII was not to be considered as marketing material[87] (but just as product information) and thus, could be used without changes across borders. If the KII does not include local (marketing) information, the justification for ex-ante checks by the host regulator will be further weakened.

Changes to the notification procedure can also have an impact on other of measures the measures analysed in this IA. For example, one of the evident conditions for the approval of fund mergers is that the receiving fund be notified in all MS were the disappearing fund is sold. A streamlined and quick notification procedure will make it easy to comply with this requirement. It should also be noted that the simplification of the notification procedure can also reinforce the consolidating effect of fund mergers. By achieving a greater openness of national markets, fund promoters will feel less the need to launch parallel ranges of funds in other to assure their presence in different MS.

87 Please see the response by IMA and the joint position of UK FSA and HM Treasury.

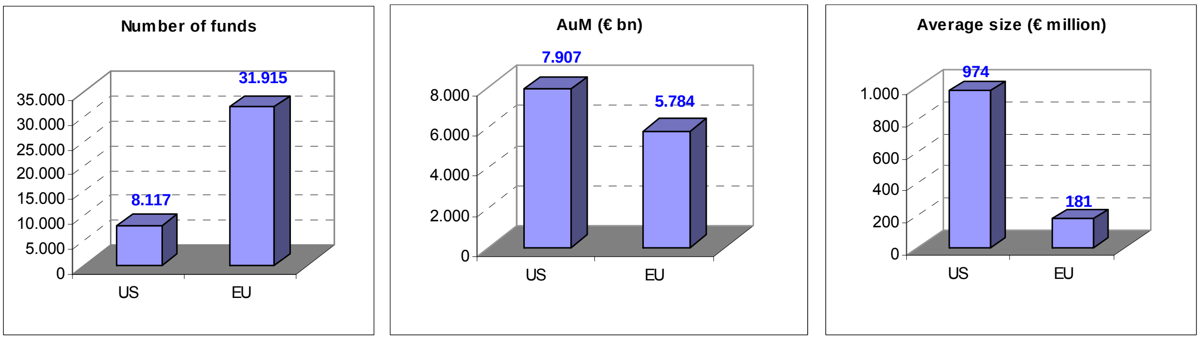
Impact table

Option	Affected parties	Effect Direct: D Indirect: I	Impacts Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Impact Timing One-off Short-term Medium-term Long-term On-going	Impact Nature Dynamic Static	Impact Likelihood Certain High Medium Low
Ex-ante control	Industry	D	- (limited costs reduction) -- (less cross-border opportunities)	on-going	dynamic	high
	Investors	D	++ (high investor protection)	on-going	static	high
		I	- (maintenance of cost levels)		dynamic	
	Regulators	D	≈ (more resources needed)	one-off	static	medium
Ex-post on-going control	Industry	D	+ (greater costs reduction)	medium-term	dynamic	medium
			+ (more business opportunities)			high
	Investors	D	+/ ≈ (protection level maintained)	on-going	static	low
		I	+ (lower costs)	long-term	dynamic	medium
	Regulators	D	+ (better resources management)	on-going	static	high

Fund mergers

Problem description

The European fund landscape is characterised by an ever increasing number of funds. Large fund ranges may render management more complex and require more investments in time, means and/or human resources at different levels of the industry value-chain. However, funds are not only numerous but also relatively small. At the end of 2006, 54 % of European funds managed less than € 50 million in assets; 20% less than € 10 million[88]. In fact, at the end of 2006, the average size of a European fund was less than a fifth of that of its American counterpart (please see graph below). As a result, the Total Expenses Ratio (TER) paid by the investor of a typical cross-border European equity fund is twice as much as that borne by American fund investors[89].



Source: ICI, EFAMA, ECB

The reason is that small sizes impede the exploitation of economies of scale and increase costs. The potential for economies of scale in fund management is not negligible. A study by Fitzrovia in 2005 showed that the TER of actively managed funds considerably diminishes with the size of the fund. According to this study funds with up to $25 million assets had an average TER 15% higher than that of a fund with up to $ 100 million assets[90]. A study conducted more recently by CRA[91] also found evidence of economies of scale in the European fund industry (the greater scope for scale savings being at the level of fund administration and asset management). Although, according to CRA, additional scale savings would fade out once the fund's size has reached €200-300 million, the fact that a high percentage of European funds are far from that size (as shown by the FERI data above), proves the importance of the economies of scale potential.

Several studies have tried to assess and quantify the missed opportunities. The so-called "Heinemann report" estimated that € 5 bn could be saved annually if the European average fund size would converge to that of an American mutual fund[92]. In 2005, an Invesco report considered that European investors were charged an estimated € 2-6 bn in annual fees more

88 FERI, Data digest 2007

89 "Economies of scale and consolidation in collective funds", Fitzrovia, March 2005.

90 Funds with up to $ 25 million assets were reported to have an average TER of 2.01% compared to 1.75% for a fund with up to $ 100 m. ("Economies of scale and consolidation in collective funds", Fitzrovia, March 2005.)

91 "Potential cost savings in a fully integrated European investment fund market", CRA, August 2006. Study based on a sample of European countries representing 90 % of the UCITS market (European Commission (2006f)).

92 "Towards a single European market in asset management", ZEW, May 2003.

than they would if scale economies could be fully exploited[93]. According to CRA annual savings of up to 17 basis points could be attained if European equity fund sizes would converge to that of the average US fund[94].

Finally, in addition to these unnecessary extra costs, it should be noted that the existence of broad fund ranges also creates confusion among distributors and investors rendering choice more difficult.

The WPIA considered that inaction was not a valid option; fund proliferation is set to continue. Fund launches remain the preferred strategy for asset managers to innovate, raise new assets and respond to new investors' needs or preferences. In 2006, the number of funds increased by 1,542 (compared to an increase of 887 funds in 2005). According to FERI, observed fund closures were sometimes the consequence of products, such as guaranteed funds, reaching maturity rather than the result of fund rationalisation efforts.

But where does the problem lie? Fund mergers do take place, notably among funds based in the same country ('domestic' mergers in the table below). However, the absence of a common EU fund merger framework has been identified as one of the main obstacles to further consolidation across borders. The coexistence of different national approaches and rules renders cross-border mergers, when at all possible, expensive, complex and time consuming. The Commission's Expert Group on market efficiency reported that often 18 months were needed to complete cross-border mergers, i.e. much more than the 3 months generally required for domestic fund mergers[95]. Difficulties derive mainly from divergences in regulatory requirements. Some criteria are seen as overly prescriptive. For instance, in some countries 100% of unit-holder approval is required. Uncertainty regarding the outcome and important delays discourage pan-European industry players as is evidenced in the table below. As a result, parallel similar ranges of funds develop in different MS markets.

Table : Fund mergers in the EU

Type of merger	2002	2003	2004	2005	2006
Domestic	452	804	583	764	644
Cross-border	1	26	57	28	7

Source: Feri FundFile

The WPIA therefore recommended changes to the Directive in order to create the conditions for the rationalisation of the fund landscape while, at the same time, ensuring high levels of investor protection. The WPIA also examined carefully the options available in order to overcome the potential adverse tax consequences of (cross-border) fund mergers. It considered the option of adopting a Directive on the 'Taxation of Fund Mergers' (as recommended by the Expert Group) and compared it to other options, including the adoption of a Communication (and the 'no action' one). The WPIA concluded that adopting a

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

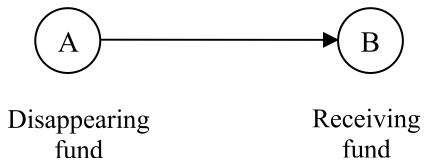
94 CRA study (European Commission (2006f)).

95 "Report of the Expert Group on Investment Fund Market Efficiency", European Commission, July 2006.

Communication was the most proportionate and cost-effective measure. This conclusion was motivated by the fact that domestic mergers have already a neutral tax treatment in many MS and that this could be extended to cross-border mergers on the basis of existing European Court of Justice case law.

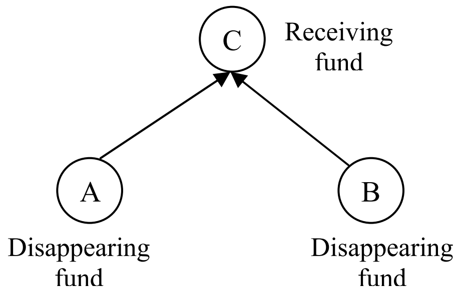
The exposure draft published in March 2007 presented stakeholders with a preliminary design of an EU framework for UCITS mergers. This framework would cover a series of commonly used merger techniques (please see the diagrams below) and would apply to both domestic and cross-border mergers. A set of requirements for the regulatory approval of mergers was put forward, the main principle being that only the regulator of the disappearing fund would approve (or refuse) the proposed merger. The exposure draft also contained specific investor protection provisions, including the right for investors to receive information on the merger and the right to redeem free of charge if they do not agree with the merger operation.

Merger by absorption / Scheme of amalgamation



The disappearing fund transfers its assets (scheme of amalgamation) or assets and liabilities (merger by absorption) to the receiving fund in exchange of units issued by the receiving fund to the investors of the disappearing fund.

Merger by creation of a new



Both the disappearing funds transfer their assets and liabilities to the receiving fund in exchange of units issued by the receiving fund to the investors of the disappearing funds.

<u>Responses to the Exposure Draft consultation</u>

<u>General principles</u>: The proposed approach was generally supported by all types of stakeholders (industry, regulators and investors). Some respondents however considered that mergers should only be allowed between UCITS having similar investment policies.

<u>Authorisation procedure</u>: Respondents generally supported the proposal that the regulator of disappearing UCITS decides on the merger, although its exact role might need further clarification. Some respondents advocated greater involvement of the regulator of the receiving UCITS in respect of disclosure items. Several contributions also stressed that 15 days was too short a period for approving the merger.

<u>Third party control:</u> Several respondents asked that the exact role and responsibilities of the depositary be clarified. Their main concern was that the depositary should not decide on the merits of the merger. A few contributors also asked to eliminate the requirement regarding the independent auditor, or at least to clarify its role.

<u>Information to unit-holders:</u> Responses offered mixed views. Some respondents considered that investors of the receiving UCITS should not be informed at all (or only at the discretion of the fund promoters), while others argued that they should always be informed or that they

should only be informed if there was a "substantial" impact. Some considered that the proposed assessment of the potential "negative" impact on the receiving UCITS unit-holders by the UCITS itself was not the right approach. Investors generally considered that the form and content of the information should be made clear and that such information should be sent to all investors automatically and not merely "on request".

Unit-holders' rights: The proposed approach to follow national regimes to determine whether or not unit-holders could vote on the proposed merger was broadly accepted. The proposed threshold of 75% of votes cast was generally welcomed. Some respondents indicated that in practice the right to redeem free of charge might not necessary provide the most optimal solution for investors, taking into account possible tax consequences and the loss of entry fees already paid. They therefore suggested to offer investors also the possibility to switch to another fund of the same promoter with similar investment policies. Views regarding the right for receiving fund investors to exit free of charge diverged. Some believed that it should be automatic; others only if the merger would have a negative/substantial impact on them. Various respondents (industry and regulators) considered that under certain circumstances, the costs of the merger could also be (partially) born by the fund/investors and not merely by the management company/promoter. This view was not shared by investors.

Finally, a non negligible number of contributions expressed concerns regarding the potential adverse tax implications of fund mergers. It was argued that, particularly in cross-border situations, mergers may be treated as a disinvestment (by the disappearing fund unit-holders) and therefore subject to capital gain taxes.

Objectives

A common EU fund merger framework will need to comply with the general objectives of the UCITS Directive (enhanced market efficiency and adequate investor protection). In addition, the design of such framework should properly respond to the different stakeholders' concerns and expectations. The framework should therefore:

a) from a single market perspective:

- Encourage the pan-European consolidation of the fund industry
- Foster economies of scale
- Promote competition

b) from an industry angle:

- Clearly state industry's obligations
- Create the minimum (administrative) burden
- Be swift

c) from the regulators' point of view:

- Allow an adequate supervision
- Clearly indicate the involved regulators' respective responsibilities
- Ensure that the interests of investors are adequately protected

d) as well as, ensure that investors:

- Are properly informed
- Have the right to dissent
- Do benefit

Benefits

The main benefits of such a framework would be:

	For investors	For the industry
Medium-term	A rationalised choice (less confusion between funds)	More manageable fund ranges
Long-term	A share of costs savings (e.g. lower fees or higher performances)	More manageable fund ranges; cost savings

Advantages will take some time to materialise. At a first stage, rationalised fund ranges will benefit both investors (and distributors), who will be presented with a less overlapping (and often confusing) fund offer, and fund providers, for whom fund ranges will be easier to manage. In the longer term, savings from economies of scale (and from the elimination of maintenance costs of the disappearing funds) would considerably reduce the costs of funds. Under the appropriate competition conditions, part of those savings will be passed on to the investor.

Design of the optimal framework

There is a certain consensus on the main features of the required fund merger framework. The analysis presented in the IOSCO's report on Collective Investment Schemes' mergers[96] and the recommendations of the Expert Group on market efficiency's report are largely convergent. The following table summarises the conclusions of both reports.

	IOSCO review	Expert Group
Regulatory approval	• Before presented to unit-holders • Verification of requirements	• Before presented to unit-holders • Disappearing fund regulator decides
Unit-holder approval	Generally in line with national company law	• Following national legislation • Threshold max. 75% of votes cast
Information disclosure	• Sufficient for informed decision • Accurate and well balanced	• Prior submission to regulator • In the language of investor's MS

96 "An examination of the regulatory issues arising from CIS mergers", IOSCO, November 2004

	• On merger rationale, continuing fund, tax implications, costs	• On investment policy, charges, valuation, voting process
Costs	• Clearly disclosed • Borne by the manager	——
Redemption	Dissenting unit-holders: possibility to redeem free of charge	Dissenting unit-holders: possibility to redeem free of charge
Third-party monitoring	Disappearing fund audited; depositary reviews proposal	Valuation audited; depositary responsible for assets transfer

On the basis of the above comparative table, it could be concluded that an ideal framework would have two basic elements: a) the approval by the competent authority (CA), and b) the right of the investor to be appropriately informed and to protect his/her interests. However, in order to efficiently implement these basic principles, some choices need to be made. The following tables identify possible alternatives. Preferred choices are presented in bold and italics.

a) Regulatory approval

Relevant aspects	Possibilities	Comments
Timing	***Before submission to investors*** After investors' approval	In line with the general practice, the first possibility should be retained. It would ensure higher investor protection since it allows the CA to check the information to be provided to investors
Competent authority (CA)	***Disappearing fund authority*** Both disappearing and receiving fund authorities (common decision) Both disappearing and receiving fund authorities (independent decision)	These 3 options were analysed in the exposure draft published in March 2007. A majority of respondents favoured the first one, as the most cost-effective. Additionally, the concerns of those asking for a more active role for the receiving fund authority could be addressed with other investor protection measures developed below.
Approval criteria	***Merger file completeness*** Similarity of investment policies	A mere formal check (1st possibility) would shorten the procedure. It is also a more objective criterion. However, it could give rise to investor protection concerns. Basing the regulatory decision on criteria such as the similarity of investment policies could increase uncertainty (difficult to define what similar policies are). On the other hand, considering only investors' interest could be redundant (if investors are given the means to protect their interests and/or

	Investors' interest	are given the means to protect their interests and/or third parties have an oversight role). A certain balance between criteria 1 and 3 could however be found (e.g. if CA assesses the risk of potential [negative] impact of the merger on investors)
Relevant aspects	**Possibilities**	**Comments**
Coverage	Only cross-border fund mergers ***All fund mergers (cross-border and domestic)***	There seems to be few obstacles to merging funds domestically. Consolidation at national level is already quite intense in certain countries, such as France where 600 domestic mergers take place every year. Therefore a framework covering only cross-border mergers could be seen as a logical choice. However, domestic mergers may have cross-border effects (e.g. in the case of the merger of two Luxembourg funds widely notified for selling across the EU). It would therefore appear appropriate to ensure that a minimum set of coherent investor protection provisions would apply to all type of mergers (cross-border and domestic).
Merger techniques covered	***By absorption*** ***By creation of a new fund*** ***Schemes of arrangement/amalgamation***	An appropriate approach seems to include the possibility of both mergers by absorption and by creation of a new fund. This would follow the example of the Cross-Border Mergers Directive[97]. However, these merger techniques are not often used for merging funds in certain MS (particularly common law countries). It may therefore be necessary to include some other commonly used merging techniques, such as schemes of arrangement/amalgamation[98].

Other relevant aspects would be the content of the merger file on which the competent authority will need to base its decision. Many different combinations of required documents could have been identified in the above 'possibilities' column. However, comparing all those possibilities would have not been quite meaningful nor would have it added much to the analysis. Instead, it is recommended to retain the list of required documents proposed in the exposure draft. This had been drawn up in line with national practices and was considered appropriate by respondents to the consultation.

97 Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies.

98 This is the merger technique most used in common law countries. It implies a transfer of assets from the disappearing into the receiving fund. The liabilities are not transferred but discharged at a latter stage. Only then, the disappearing fund will be wound up. Inclusion of this merger technique was explicitly recommended by the Expert Group on market efficiency.

b) Investors' rights

Relevant aspects	**Possibilities**	**Comments**
Information	Only to disappearing fund investors To both funds' investors	Investors will need to be informed about the merger's and its potential impacts in order to take a decision. Considering that investors of the disappearing fund will be the most affected by the merger, the less burdening measure would be to inform only those. However, in certain cases, information to the receiving fund investors may also be appropriate (particularly if the merger risks having a negative/substantial impact on them). Both options deserve therefore to be carefully looked at in the following section.
Possibility to redeem free of charge	Only for disappearing fund investors To both funds' investors	Again, as the investors of the disappearing fund are those most affected by the merger, it seems logical that at least such investors would have the possibility to redeem without charge if they don't agree with the merger. However, it may also be appropriate to give the same possibility to receiving fund investors (particularly if the merger risks having a negative/substantial impact on them).
Vote on the merger	Only disappearing fund investors Both funds' investors ***According to national law***	All investors should be able to decide on the merger of the fund they invested in with another. However, an investor vote is not always the normal practice (in some MS and/or for some fund types) and voting rules often are linked to company law provisions. In addition, investors rarely play an active role. Other investor protection issues seem therefore more cost-effective without interfering with national laws and practices.
Costs of the merger	***Not charged to investors*** Shared between fund manager and investors	Fund mergers are often the result of a commercial decision by the fund provider. It would therefore appear appropriate that the costs associated to the merger are borne by the fund provider and not by investors. On the other hand, investors should also benefit in the medium to longer-term from the efficiency savings achieved. The second option would then need to be reinforced with provisions guaranteeing the passing on to investors of some of the savings. This may be, however, difficult to implement in practice and risks creating legal uncertainty.

Impacts analysis

The tables above provide an overview of the main features a fund mergers legal framework should ideally have. In some cases, the choice among the different available possibilities is uncomplicated. In others, a more in-depth analysis is required. This is particularly the case for the obligation to send information on the merger to investors and the right to redeem free of charge. In both cases the options are the same and the implications similar (particularly from an investor protection point of view). The following analysis will thus focus on only one of these cases, more specifically the information obligation. The conclusions can then be extended to the "right to redeem free of charge" case.

As indicated, two options have been identified:

(Note: the option "no information at all" is for obvious investor protection reasons ruled out)

Option 1: Only to disappearing fund investors

The rationale behind this option is that the investors of the disappearing fund are those most affected by the merger. The merger should in principle not have any significant implications on investors of the receiving fund. The investment policy of the receiving fund remains the same and the merger would usually have an impact similar to that of a big subscription into the fund.

Option 2: Always to both funds' investors

The rationale behind this option is that both the disappearing fund and the receiving fund investors have a right to be informed of the possible impacts of the merger on them. (Additionally, information to the receiving fund investors will need to be provided for in any case if national law foresees their vote on the merger.)

This option was vehemently supported by investor associations (FIN-USE, Financial Services Consumer panel, Test-achats, Verbraucherzentrale Bundesverband) in their responses to the exposure draft consultation. Some national authorities also considered that receiving fund investors should receive the information whatever the impact of the merger on them was (Finnish Ministry of Finance, Dutch regulator). On the other hand, industry players tended to favour a facultative approach, i.e. leaving to the fund promoter the decision to inform or not investors in the receiving fund (e.g. AFG, JP Morgan, Pioneer, Unitcredit Group) or imposing it as a requirement only if the impact on the receiving fund investors would be substantial (e.g. ALFI, State Street).

Option 1: Only to disappearing fund investors

Impacts from the point of view of:

a) **Industry**: Preparing information adapted to both types of investor should not be overly onerous (often the relevant information/documents will be similar). However, distributing it will definitely be onerous. Requiring the provision of information only to disappearing fund investors would considerably limit the administrative burden on industry players. Lower merger costs should then encourage further fund consolidation[99].

b) **Investors**: For the receiving fund investors, the merger would most often have no perceptible impact. There is a risk of performance dilution due to the transfer of assets from the disappearing fund into the receiving fund, but this could be mitigated with techniques

99 If, as recommended in the 'investors' rights' table above, these costs cannot be passed on to investors, fund providers will be more reluctant to propose fund mergers.

already well-known by fund providers[100]. A 'dilution levy' could be applied to reduce the impact of cash transfers (as is already commonly done for big subscriptions). With regards to the securities transferred, these may need to be sold in order to rebalance the portfolio of the receiving fund. This could be done during a long enough period in order to alleviate potential negative effects on the performance. In some cases a realignment of the portfolio of the disappearing fund in line with that of the receiving fund takes place before the merger in order to mitigate any potential performance dilution[101]. The risk however exists that, particularly when investment policies differ significantly, the rebalancing of portfolios would still have a definite negative impact on the performance. If receiving fund investors are not properly informed of this risk they will not be able to act consequently and would therefore not be adequately protected.

c) **Regulators**: Providing merger information only to the disappearing fund investors could give rise to supervisory concerns. The authority responsible for the receiving fund may feel unable to fulfil its obligations towards investors. To mitigate these concerns greater safeguards would be required. The decision of the disappearing fund regulator may then need to be based not only on a formal/completeness check of the merger file but would also need to take into consideration the interest of investors. (This would require a greater reliance on the judgement of the disappearing fund regulator by the other regulators involved).

Option 2: Always to both funds' investors

Impacts from the point of view of:

a) **Industry**: A considerably high administrative burden will need to be assumed by industry players. Distribution and translation costs may be considerable[102], notably if the receiving fund has been notified for marketing in several MS. (According to PWC/Lipper data, at the end of 2006 the typical cross-border fund is notified for selling in at least 7 countries[103].) A longer preparation period (for the drafting and translation) will most probably also be necessary. This would delay the completion of the merger and therefore the achievement of the savings pursued.

b) **Investors**: Although the impact to receiving fund investors most often would not be important, the risk of performance dilution as explained above remains in certain cases (notably when the investment polices of the funds merging significantly differ). In such cases, receiving fund investors would only be properly protected by receiving information on the merger (so as to allow them to exercise their rights)[104]. On the other hand, this information requirement could be seem as burdensome by the industry and effectively discourage mergers. In the absence of fund consolidation activity, investors would then continue to pay unnecessarily high fees (please see problem description above).

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100 Please see Pioneer's response to the exposure draft consultation.

101 Please see State Street's response to the exposure draft consultation.

102 These costs would be extremely difficult to quantify even for a single merger since it would depend on the number of investors and from how many MS they are from (which determines the distribution method and the language of communication). Extrapolating this quantification to the estimated number of potential mergers would make little sense.

103 "Global Fund Distribution 2007", Price Waterhouse Coopers and Lipper, 2007.

104 Information should also obviously be provided whenever the receiving fund investors are entitled, under the relevant national provisions, to vote on the merger.

c) **Regulators**: Having to check the information prepared for the receiving fund's investors in addition to that prepared for the disappearing fund's ones should not add a significant additional burden to the regulators' work. As explained above, contents would be largely similar. Regulators would however also need to verify whether the information on the merger has been provided to investors according to the (language and distribution) requirements in the Directive. When the information is provided to both disappearing and receiving funds' investors, more resources should be deployed on the side of regulators. If investors of the receiving fund are not to be affected by the merger, the deployment of additional regulator resources may not be adding much to their protection.

<u>Other effects</u>

Administrative burden: although the choices in the above sections have been made with the objective to minimise the administrative burden for the industry, the creation of a legislative framework for mergers could be seen as introducing additional (administrative) requirements. It needs to be noted however that the harmonisation of the merger procedure sought by the new provisions would considerably reduce the administrative burden actually borne by fund promoters wishing to merger funds cross-border (and who currently need to comply with a set of different national requirements). Under the proposed framework, a single merger dossier for a single regulator (that of the disappearing fund) will need to be prepared.

<u>Summary table</u>

	Specific Objectives			**Overall Objective**
	Investor protection	**Efficiency** **administrative burden**	**sector efficiency**	**Pro Single Market?**
Only to disappearing fund investors	- *(protection risk for receiving fund investors)*	+ *(lower burden)*	+ *(higher scale savings)*	yes *(potentially more mergers)*
To all investors	+ *(all investors duly protected)*	- *(higher burden)*	- *(lower scale savings)*	no *(may discourage mergers)*

<u>Preferred option</u>

Under certain circumstances (please see above) the performance of the receiving fund may be negatively affected by the transfer of assets. In those cases, it would appear normal, for the sake of investor protection, that all involved investors would be adequately informed of that risk. Additionally, all investors should be also given the means to opt-out of the merger (e.g. by offering them the possibility to redeem free of charge or to switch with no entry fees to another fund). However, considering that in many cases the risk of detriment for the receiving fund investors is limited and that measures exist to mitigate the merger potential performance dilution, it would be unnecessarily burdensome to require that receiving fund investors are systematically informed. Thus, neither of the options seems to be optimal: the first one from the investor point of view, the second from the efficiency point of view.

A combination of both options would therefore provide a more proportionate solution. This could require that information is always provided to disappearing fund investors but that the need to send it also to receiving fund investors would be assessed by the regulator responsible for the merger approval[105], i.e. the regulator of the disappearing fund. This regulator's decision could be then based on the potential impact of the merger on the receiving fund investors. Since the main negative potential impact on them is of a purely technical nature (i.e. the dilution of performance explained above), the regulator of the disappearing fund should be able to asses that risk (as it is already currently done for national mergers)[106]. In any case, some form of communication or co-operation between regulators could also be considered. For example, the possibility for the regulator of the disappearing fund to consult with the regulator of the receiving fund before taking a decision.

<u>Other (general) considerations</u>

A number of stakeholders during the exposure draft consultation have highlighted the possibility of negative tax implications of cross-border mergers. It needs, however, to be pointed out that no new arguments have been provided (nor the conditions/situation have changed) to justify a revision of the WPIA conclusion in this respect. A Commission Communication remains therefore the preferred option.

Fund mergers will often be considered as mere internal restructuring operations. However, in certain cases[107], they may give rise to competition related considerations. In such cases, attention should be paid to compliance with national or EU competition rules (if the merger has an EU dimension[108]).

'Merger' and 'rationalisation' are often associated with negative social impacts. In the case of fund mergers, the constant high rhythm of launching new funds should compensate for any such impact. (If redundancies are to be expected in the asset management business, they would most probably be rather linked to the automatisation of functions and processes than to fund mergers.)

It could also be argued that the greater overall size of UCITS may have some effects in terms of investment strategies. The Directive concentration rules (article 25), could then oblige managers to change their investment focus, particularly if the fund invests in specific or less liquid sectors/markets or in small companies. However, it can be expected that most often managers will tend to increase the diversification of their portfolios rather than changing strategies. Also, considering the global size of capital markets (the world market capitalisation for equities and bonds was $51 tr. and $ 30 tr. respectively at the end of 2006) and the current average size of European funds (€ 181 million as showed in the graph at the beginning of this section), greater fund sizes should not importantly change investment strategies.

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105 Unless this is in any case mandatory because the merger requires a vote by the receiving fund investors, in which case information on the merger is to be provided prior to the unit-holders' meeting in accordance with national rules.

106 Given the technical nature of the performance dilution effect, no particular knowledge of the local rules in the country of the receiving fund should be required.

107 e.g. the merger of two funds of two different asset management companies (without those asset management companies merging themselves). It could therefore been argued that the merger may lead to concentrations that may be not fully compatible with effective competition in the common market.

108 The 'EU dimension' of the merger would need to be assessed taking into account turnover and other requirements. Given the required level of the turnover thresholds and the small size of average EU fund, it is however quite unlikely that the merger of respective funds would fall in the above category.

Finally, there is a close relation between fund mergers and some of the other measures discussed in this impact assessment. First of all, asset pooling. Although fund mergers and pooling may pursue similar goals (economies of scale in asset management), they are not to be considered as alternative but rather as complementary measures. Opting for one or the other will depend on the business model adopted: mergers might be more appropriate for industry players wishing to offer a (cross-border) fund range from a single location; while pooling might be more appropriate for those offering a range of (national) funds established in several MS. Second, given the need to provide appropriate information to investors on the proposed merger operation, a streamlined Simplified Prospectus (or Key Investor Information) could play an important role in facilitating the comparison between the funds merging. Finally, it would be advisable that the receiving fund be notified to the relevant authorities in all MS where the disappearing fund was sold to investors. A simplified notification procedure would make it easier for the industry to comply with this requirement.

Impact table

Option	**Affected parties**	**Effect** Direct: D Indirect: I	**Impacts** Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	**Impact Timing** One-off Short-term Medium-term Long-term On-going	**Impact Nature** Dynamic Static	**Impact Likelihood** Certain High Medium Low
Only to disappearing fund investors	Industry	D	++ (lower merger costs)	short-term	dynamic	high
			++ (greater potential for scale savings)	medium-term		
	Investors	D	- (performance dilution)	short- to medium-term	dynamic	low
		I	+ (lower costs)	long-term	dynamic	medium
	Regulators	D	+/- (easier supervision; investor protection concerns)	one-off	static	medium
To all investors	Industry	D	-- (higher merger costs)	short-term	dynamic	medium
			- (lower potential for scale savings)	medium-term		
	Investors	D	++ (maximum protection)	on-going	static	high
			- (higher costs)		dynamic	low
	Regulators	D	+/- (more resources for supervision; lower inv. protection concerns)	one-off	static	medium

Asset Pooling

Problem description

The above IA fiche on fund mergers describes in detail the difficulties derived from the proliferation of funds in the European fund market. Management of growing ranges of small funds becomes increasingly difficult. As explained, that proliferation does not only lead to greater operational risks but, most importantly, it hinders the exploitation of economies of scale. Ultimately, this results in important (unnecessary) costs for investors. Missed economies of scale annual savings amount to billions of euros[109].

The WPIA identified asset pooling as a complementary solution to mergers. In fact, in certain business cases, mergers may not be the optimal (or the most desirable) way to achieve economies of scale. Cross-border fund mergers will lead to the disappearance of less efficient (and overlapping) funds based in different domiciles while helping fund promoters to develop big funds serving several MS markets from a single location. However, local presence may sometimes be preferred. This would allow fund promoters to better adapt fund features (e.g. charging structure) to investors' preferences in different national markets. In that case asset pooling would provide a more appropriate solution. Pooling also facilitates product innovation and a manager of managers' approach since it allows leveraging the know-how of a set of specialised fund managers[110]. The most common pooling techniques are described in the box below[111].

Main asset pooling techniques

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

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

Pooling have been widely used in some EU jurisdictions but limited to funds in the same domicile. However, to better exploit potential scale economies the Expert Group report on Market Efficiency recommended developing pooling on a cross-border basis.

Pooling savings could be achieved at three different levels: 1) front-office: pooling lowers managers' overheads since a single manager could manage a higher number of assets; 2) middle and back-office: higher average transaction sizes and fewer trading accounts benefit

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109 Please refer to the merger fiche for further details on the consequences of the proliferation of sub-optimal sized funds.

110 FEAM response to the Green Paper consultation, 31st October 2005.

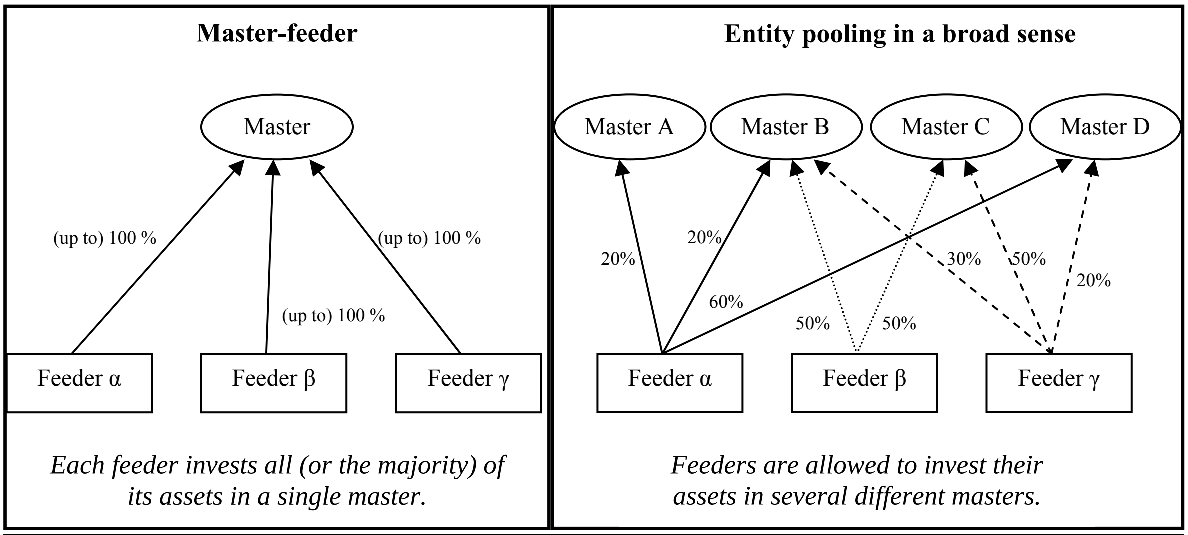
111 For a more detailed description of the different pooling techniques please see the Appendices to the report of the Expert Group on Investment Funds Market Efficiency (European Commission (2006c).

from lower service-provider fees; and 3) trading execution: grouped trades face more competitive spreads. Since many of these savings occur at the fund level, they are automatically passed on to investors.

Obstacles to cross-border pooling in the UCITS framework were analysed in the WPIA. In the case of virtual pooling, these structures are not prohibited by the UCITS Directive. They are nevertheless regarded as complex and requiring important investment in IT systems. As regards to entity pooling, it would seem easier to implement and to supervise. However, entity pooling is prevented by the Directive's diversification requirements. Withholding taxes could also have a negative impact if the entity pooling the assets is not fiscally transparent[112].

In the case of virtual pooling, the WPIA analysis let the door open to the introduction of a common approach but recommended to give further consideration to the issue. Subsequent research on this area led Commission services to conclude in the exposure draft that it did not seem appropriate at that stage to take any measure to create a pan-European environment for virtual pooling. Important cross-liability and other investor protection concerns were highlighted as the main reason. Additionally, it appeared that the use of this technique was not much extended outside a few MS and that there did not exist cross-border virtual pooling experiences. Besides, there had not been strong demands on the industry side for such an environment[113]. Analysis of the issues blocking the cross-border development of virtual pooling should therefore be first discussed in appropriate fora. More detail on these considerations is provided at the end of this fiche.

On the other hand, the WPIA report concluded that the UCITS Directive should be changed to allow entity pooling. However, no detailed analysis was provided on the scope of this new freedom; i.e. should entity pooling in a broad sense be allowed or should changes to the Directive be limited to allow only the so-called 'master-feeder' structures? These concepts are described graphically in the boxes below.



Each feeder invests all (or the majority) of its assets in a single master.

Feeders are allowed to invest their assets in several different masters.

112 "Pooling: how can fund managers respond efficiently to different investors needs?", IMA, July 2005.

113 Contributions to the consultations on the Green Paper and the Expert Group report on Market Efficiency had showed a greater interest for entity pooling (particularly master-feeder structures). As explained below responses to the exposure draft have confirmed this position.

The exposure draft presented an outline of the changes to the UCITS Directive necessary to provide a framework for entity pooling. On the basis of a preliminary assessment of impacts, the exposure draft proposals concentrated on master-feeder structures. The main characteristics of that proposed preliminary framework were the following: a) prior regulatory approval of the feeder's investment into the master was required, b) pooling structures needed to have at least two feeders, c) the minimum investment of the feeder into the master was fixed at 85% (of the feeder's assets); d) proper arrangements between master and feeder (and between its depositaries and auditors) needed to be in place; e) information to investors should clearly explain the implications of the two-layer investment; and f) both master and feeder, as UCITS, needed to comply with the Directive provisions

Responses to the Exposure Draft consultation

Scope: Almost half of those commenting on the issue supported the proposed focus on master-feeder structures. Others, while also in favour of master-feeders, said to welcome in the future the possibility of using entity pooling in a broad sense. Several respondents defended the creation of a framework for entity pooling in a broad sense. They considered that limiting the scope only to master-feeders was a missed-opportunity. Very few respondents pleaded for provisions to permit virtual pooling.

Approach: Commentators found the framework rather prescriptive. They recommended to distil the key regulatory principles from the exposure draft, leaving details on procedure or application of principles to specific scenarios to be filled in through implementing legislation or common supervisory practice.

Two-feeder requirement: The vast majority of respondents considered it unnecessary to require that a master should have at least two feeders.

Agreement between feeder and master: Several industry stakeholders pleaded for the removal of the envisaged requirement for a formal agreement between master and feeder funds. On the other hand, a number of regulators and investor associations welcomed the proposal. They stressed that it would clarify the respective responsibilities of feeder and master funds.

Feeder's responsibility: Several industry stakeholders claimed that the feeder should only be responsible for selecting the master. The feeder fund should then be able to rely on any information it receives from the master. This point of view was contested by those who argue that master-feeder structures should be treated as a form of (management) delegation and, therefore, the delegating entity (feeder) should remain responsible and be fully accountable to its unit-holders.

Feeder depositary/auditor's role: Several industry stakeholders opposed the idea that the feeder depositary/auditor should be obliged to monitor whether the master fund was operated in line with the obligations binding on the feeder fund. In their view, they should be able to rely on the information they receive from the master's depositary/auditor. Other respondents (notably regulators and investor associations) defended the envisaged approach arguing the master-feeder structures were comparable to a delegation of the asset management.

Info-sharing agreement between depositaries/auditors: Several industry stakeholders criticised the need for a formal info-sharing agreement between the depositaries/auditors of the feeder and master funds. They claimed that the costs would outweigh the benefits. On the other hand, several regulators, but also some industry representatives argued that the info-sharing agreements were needed in order to allow these actors to comply with their obligations.

Investment into the master threshold: Most stakeholders agreed with the envisaged requirement that the feeder invest at least 85% of its assets in the master.

Derivatives: Respondents discussed whether, for what purposes and to what extent a feeder should be able to hold derivatives. A few respondents argued that no specific restrictions on the feeder's use of derivatives should be contemplated. However, others favoured restricting the use of derivatives to a few specific situations (e.g. hedging currency risk).

Objectives

A legislative framework for entity pooling should properly address the different stakeholders' concerns and realise their expectations. This framework should therefore:

a) from a single market perspective:

- Facilitate the cross-border pooling of assets (and thus encourage scale savings and specialisation gains)
- Encourage a broader fund offer

b) from an industry angle:

- Facilitate the reaping of economies of scale related savings
- Create the minimum (administrative) burden
- Allow a high degree of flexibility in the management of pooling structures

c) from the regulators' point of view:

- Allow regulators to fulfil their supervision and investor protection duties
- Be clear as regards regulators' respective responsibilities

d) as well as, ensure that investors:

- Have access to an enlarged and innovative fund offer adapted to their needs
- Are properly informed of the implications of investing in a two-layer structure
- Are adequately protected

Benefits

The main benefits of that new framework would be the following:

	For investors	**For the industry**
Short-term	A large fund choice; lower costs	Lower costs
Long-term	A greater fund choice; lower costs	More business opportunities; lower costs

Costs savings will materialise rather quickly once the entity pooling structures in place. Since many of these savings will take place at the fund level, investors will benefit directly from them (most probably in the form of higher performances). A facilitated framework for entity pooling will also encourage product innovation[114]; enlarging thus investor's choice and industry's business opportunities in the medium to long-term. Lower costs and greater business opportunities should also have durable positive dynamic effects on the European economy.

Design of the new pooling framework

Preferred choices are presented in bold and italics.

Relevant aspects	Possibilities	Comments
Minimum pooling require-ment	At least two feeders ***No minimum requirement***	The exposure draft's requirement for at least two feeder funds to pool into a master responded to investor protection concerns. Particularly, the risk that pooling would be used just to create double cost-layer structures. However, this does not appear to be the most cost-effective approach to deal with this risk. It implies cumbersome administrative procedures that could not only outweigh potential pooling savings but, at the end of the day, also increase the costs paid by the investor. Adequate and transparent disclosure provisions (e.g. clear information on the implications, including costs, for the investor of the pooling structure) seem a most proportionate way to achieve investor protection[115].
Regulatory approval	No regulatory approval ***Regulatory approval by the feeder's competent authorities (CA)*** Regulatory approval by both the master's and the feeder's CA	The investment of the feeder into one (or more) master(s) having potentially important consequences for the investors of both the master and the feeder, the first possibility does not seem to be appropriate from an investor protection point of view. Requiring the approval of the CA of both the master and the feeder could be too burdensome and discourage cross-border structures. Since investors of the feeder are most directly affected by the two-layer investment, involvement of only the feeder's CA appears more appropriate[116].

114 Pooling allows fund promoters to offer a series of (feeder) funds with different characteristics (e.g. covering or not currency risk, with or without capital guarantee) even if they are all invested in the same master.

115 Furthermore, even in those cases where a master fund would have only one feeder fund, the master may also pool assets from direct investors. The two-feeder requirement is therefore overly prescriptive since a one-feeder-structure also enables the pooling of assets and thus the achieving economies of scale.

116 The main negative consequence of the pooling structure on the master investors (other than the feeder) would be linked to the impact of the feeder's subscriptions and redemptions on the master's performance. However, as explained in the fund merger IA fiche, industry players have the tools to deal with performance dilution risk. Imposing additional regulatory control (by the master's CA) would probably not enhance significantly investor protection and would render the procedure considerably cumbersome.

Relevant aspects	Possibilities	Comments
Relation between master and feeder	Rights of the feeder vis-à-vis the master set out in the Directive ***Existence of agreement required for approval*** Master and feeder free to organise their relation	Directly laying down in the Directive all the rights of the feeder vis-à-vis the master was considered ahead of the preparation of the exposure draft. It was however rejected since it appeared as a burdensome and inflexible solution (any need to update those rights would require changes to the Directive). The requirement for feeder and master to enter into an agreement was also criticised by several (mainly industry) respondents to the exposure draft consultation. They pointed out the increased costs and lack of flexibility that the requirement would entail. Despite this, some form of (working) arrangement would be necessary for investor protection reasons. This would ensure that the feeder can meet its obligations vis-à-vis its investors. In order to mitigate the risk of higher costs and operational rigidity, a principle-based requirement (allowing master and feeder enough flexibility to efficiently organise their relation) could be envisaged
Relation between master & feeder's depositarie s/auditors	Info-sharing requirements set out in the Directive ***Info-sharing agreements to be entered into*** Relevant actors free to organise their relation	Again, introducing a detailed set of information-sharing provisions in the Directive would create a rather onerous and inflexible framework for the relation between the relevant actors. On the other hand, the requirement for depositaries/auditors of the master and feeder to set up information sharing arrangements was also considered burdensome by some (industry) respondents to the exposure draft consultation. As in the case of the agreement between master and feeder, info-sharing arrangements appear necessary since they aim to ensure that the depositaries/auditors of both master and feeder are able to fulfil their duties (enhancing thus investor protection). As explained above, the corresponding legislative provision could however consist of a (simple and) principle-based requirement.
Feeder's investment into the master(s)	No minimum investment required	Allowing the feeder to invest any proportion of its assets in the master(s) would give the feeder's manager more leeway in dealing with investors' subscriptions or redemptions. On the other hand, fixing a relative high minimum investment requirement would ensure greater transparency (and reliability) of the pooling structure. It can also be considered as an effective way to link the

	Minimum investment required	can also be considered as an effective way to link the investment policies of master and feeder. The 85% minimum investment threshold proposed in the exposure draft was generally regarded as adequate. The remaining (free invested) 15% was considered to allow the feeder's manager to adequately manage (subscriptions and) redemptions. In any case, the choice between these two possibilities will depend on the entity pooling option finally chosen (please see analysis below)

Relevant aspects	**Possibilities**	**Comments**
Use of derivatives	Unrestricted use Restricted qualitatively and quantitatively ***Restricted only quantitatively***	Investment in derivatives is, under certain conditions, allowed by the UCITS Directive for portfolio management purposes. Imposing quantitative restrictions to their use would make sense from an investor protection point of view (e.g. derivatives could be included in the above 15% threshold and the global exposure of the pooling structure relating to derivatives limited). Some respondents to the exposure draft consultation argued in favour of introducing also qualitative restrictions. In particular, it was considered that the use of derivatives should only be allowed for currency hedging purposes. While this would appear as offering greater protection to investors, other measures could be sufficient to that end (e.g. limiting the pooling structure's global exposure). It would also be inconsistent with the current Directive approach which does not limit investment in derivatives to that particular use.
Feeder's role	***Only selecting the master(s)*** ***Selecting the master(s) and close on-going monitoring of its/their activities***	The fact that the master is a UCITS (as proposed in the exposure draft) should provide an additional layer of protection for investor. Requiring that the feeder monitors the master may then lead to a redundant use of resources. However, as rightly pointed out by some respondents to the exposure draft consultation, pooling could be considered as a form of delegation (and therefore the delegating feeder should retain responsibility). Additionally, the feeder, as any other UCITS, has a number of obligations vis-à-vis its investors and would therefore need to monitor somehow the activities of the master. In order to avoid any duplication of costs (that are ultimately passed on to investors) the preferred solution would be the first one (only selecting the master) coupled with some monitoring elements that would allow the feeder to comply with its duties.

Conversion of UCITS into a feeder UCITS	Investors not informed Investors just informed ***Investors informed + right to redeem free of charge***	Transforming an existing UCITS into a feeder one implies a change of investment policy. This should ideally be communicated to investors before it takes place[117]. The first possibility should therefore be excluded for investor protection reasons. However, introducing a simple information obligation may not be enough to protect investors' interests. They may find themselves owning shares of a fund quite different to that into which they had originally invested and that does not respond anymore to their particular needs. They should then, as in the case of fund mergers, be offered the right to redeem free of charge.

Impacts analysis

The tables above provide an overview of the main recommended features for an entity pooling framework. Many of the choices are uncontroversial. Others are influenced by the type of pooling technique chosen. As explained before, the preferred technique presented in the exposure draft was 'master-feeder' structures. Responses to the consultation show that this choice is not without critics. The corresponding advantages (and disadvantages) of both master-feeders and entity pooling in a broad sense are discussed below in more detail. However, comparison in quantitative terms is difficult given the absence of relevant data.

Option 1: Entity pooling in a broad sense

The Directive already allows UCITS to invest in other funds. Funds of funds[118] rules were introduced with the 2001 amendments in line with the Directive's underlying principles, i.e. by enlarging the list of assets eligible for UCITS to invest into (i.e. funds) and by extending the diversification criteria to this new eligible asset. Allowing entity pooling in a broad sense would require to reconsider (or eliminate) those diversification criteria. In order to overcome any concerns derived from this relaxation of the diversification rules, the Expert Group on market efficiency recommended that both feeder and the masters be UCITS.

Impacts from the point of view of:

a) **Industry**: The possibility to use this pooling technique would bring important advantages to industry players. Flexibility to tailor feeder funds' composition would allow fund promoters to adapt quicker their fund ranges to changing trends and investors' demands. This pooling technique would also facilitate the access to the best investment managers (and should encourage competition between them). It could be argued that these advantages are already available (although to a lesser extent) to industry players thanks to the current funds of funds regime. Nevertheless, entity pooling in a broad sense would increase the industry's leeway[119].

117 Changes to a fund's investment policy would, in some MS, even require the approval of investors. However, this is not a universal practice (and depends on the legal form of the fund).

118 A fund of funds is a fund whose portfolio is basically made of funds (and liquidity). This structure is however typically not used for the purpose of pooling assets but of asset allocation and diversification. Funds of funds' investors can therefore take advantage of the expertise of different asset managers and invest into a generally highly diversified (and therefore less risky) financial product.

119 UCITS can invest only up to 20% of their assets into a single fund (Article 24). Entity pooling in a broad sense would imply that a (feeder) UCITS can invest any proportion of its assets in any chosen number of (master) UCITS.

As regards to the potential savings offered by this technique, according to a number of industry responses to the exposure draft consultation, entity pooling in a broad sense would lead to greater efficiency gains than master-feeder structures[120]. However, if the objective is to achieve economies of scale through the pooling of assets, this seems to be more easily attained through master-feeder structures[121]. There is also the view that the costs of the entity pooling in a broad sense model are not negligible. Supervision by the manager of the resulting structure will require robust compliance monitoring infrastructure. This could push up the costs of setting-up these structures. Subscriptions/redemptions into/from the feeder need to be allocated proportionally (between the masters) and would entail a high number of operations than for a master-feeder structure. An important number of working arrangements between feeder and masters may also need to be entered into, further increasing costs. It needs however to be noted that many of these are one-off costs (contrary to the expected benefits).

b) **Investors**: They would undoubtedly have access to a wider range of funds. Scale savings should also flow down the fund value-chain to investors. Investors may however find more difficult to understand the implications of the double-layer investment that this technique implies. It could be said that this is not different from the case of funds of funds (or master-feeders structures) and could be dealt with through specific information obligations (e.g. regarding the total costs of the structure). There remains however an additional source of complexity (vis-à-vis master-feeder structures). This is the fact that the feeder's investment policy and performance depends on that of a number of masters. It needs also to be noted that investors associations expressed little support for this option during the exposure draft consultation.

c) **Regulators**: The analysis ahead of the exposure draft publication concluded that entity pooling in a broad sense structures would render more difficult its oversight by the regulator, the fund administrator and the depositary; what was a clear cause of concern from an investor protection point of view. While several industry respondents defended during the exposure draft consultation their ability to effectively monitor these structures, regulators often expressed a greater unease. Several highlighted the potential confusion with fund of funds structures and the fact that it was a less well-known entity pooling technique. Greater resources on the side of regulators would seem therefore to be needed in order to ensure appropriate oversight.

Option 2: Master-feeders structures

Implementation of option 2 will imply extending the UCITS framework to a technique that is already employed at national level in some Member States. Master-feeder structures are used to offer investors access to management capabilities that do not exist 'in-house' (e.g. using 'white labelling'), to adapt products to different investor preferences[122] and/or achieve economies of scale. Since UCITS cannot invest more than 20% in another fund, existing feeders cannot take advantage of the UCITS passport and therefore can only access national investors. Giving the possibility to set-up master-feeders on a cross-border basis will boost the potential for scale savings of these structures.

120 Unfortunately, no data seems to be available in order to give an idea of the size of these potential extra gains.

121 For a master in an 'broad entity pooling' structure to attain the same size as a master in a 'master-feeder' structure, a more important number of feeders need to pool their assets into it.

122 For example, offering investors the same fund: one denominated in the fund currency (e.g. dollar) and the other in the investor's currency (e.g. euro) by hedging the currency risk.

Impacts from the point of view of:

a) **Industry**: Master-feeder structures would not offer the degree of flexibility sought by the some industry players. Its efficiency potential would therefore seem more limited. However, this technique seems to better achieve the pooling objective by putting the assets of different feeders into a single master. Thus, the potential for economies of scale (and therefore savings) should be higher. Set-up costs should also be lower. On-going administration (including performance attribution) should be also simpler than in the case of entity pooling in a broad sense.

b) **Investors**: Investors support to master-feeders during the exposure draft consultation was neither strong (although more a 'no objections' position than in the case of option 1). The main concern for investors' associations related to how cost savings would flow down to investors. As explained above, economies of scale could be more quickly achieved with this technique than by using entity pooling in a broad sense structures. Running costs should be then rapidly reduced and investors would benefit from this. (As an example of that savings potential, it could be noted that the average Total Expenses Ratio of a Luxembourg fund of assets under US $ 5 million is more than twice that of a fund over $ 250 million[123].) As in the case of entity pooling in a broad sense, proper investor protection would require clear disclosure of the risks and costs associated to the two-layer investment.

c) **Regulators**: Most regulators during the exposure draft consultation favoured this option. The main reasons were its lower degree of complexity, the fact that the use of this technique has already a positive track-record and the potential confusion with fund of funds structures of entity pooling in a broad sense. Monitoring of the master-feeder structure is facilitated by the fact that both master and feeder have similar, if not identical, investment policies. The regulator's role appears therefore simpler both at the level of the initial authorisation of the structure and during its on-going supervision.

Other effects

Impact on SMEs: One suggestion made by the Expert Group on market efficiency could help to avoid the confusion between entity pooling in a broad sense and fund-of-funds structures. This is that the asset manager of both master and feeders be the same (or that they belong to the same asset management group). This would imply that small fund promoters may not have the sufficient mass of assets to be able to attain the scale savings sought by entity pooling in a broad sense[124]. Also the ability to gain access to the best managers would be diminished.

Tax considerations: Potential tax implications have not been explicitly taken into account in the above analysis. The WPIA report stressed that withholding tax could be an issue as regards entity pooling (both in a broad sense or master-feeder structures). An IMA report in 2005[125] pointed out that the assets of feeder funds that benefit from tax treaty entitlements would need to be pooled into a fiscally transparent entity (master) in order to continue enjoying that tax advantages. (In fact, MS such as Ireland have developed transparent vehicles for this purpose.) This would therefore restrict the benefits of entity pooling to certain type of structures. Accordingly, both that report and the expert group on market efficiency put

[123] "Economies of scale and consolidation in collective funds" Lipper, March 2005.

[124] As explained before, entity pooling in a broad sense requires a higher number of feeders per master than master-feeder structures in order to achieve the same degree of pooling.

[125] Please see footnote 98.

forward as a solution to work on a common approach to fiscal transparency, developed through the auspices of the OECD. On that basis, an in line with the strong stakeholder support for action in this area, the WPIA considered that the risk of potential negative tax implications was not an obstacle significant enough not to proceed with the creation of a facilitating framework for entity pooling structures. It concluded however that, investors should be fully informed of the potential tax implications (e.g. in terms of lower returns) that the use of this pooling technique may entail. No new elements to this debate have been provided during the exposure draft consultation.

Administrative burden: The possibility for UCITS managers to engage in entity pooling will introduce new opportunities for the industry but also new obligations and therefore additional administrative burden. However, the additional administrative burden appears justified by the need to ensure adequate levels of investor protection. It needs to be noted that given the greater complexity of 'entity pooling in a broad sense' structures, additional investor information obligations may need to be imposed on fund providers. Thus, the negative impact on administrative burden of option 1) risks been greater. As regards to the other recommendations put forward (please see 'choices' tables above), they aim at reducing the administrative burden by clearly identifying the industry's responsibilities.

Summary table

	Specific Objectives			**Overall Objective**
		Efficiency		
	Investor protection	**administrative burden**	**sector efficiency**	**Pro Single Market?**
Entity pooling broad sense	- *(supervisory concerns)*	- *(higher burden)*	+ *(higher flexibility lower ec. of scale)*	yes *(will encourage market integration)*
Master-feeders	+ *(more well-known and positively tested)*	+ *(lower burden)*	+ *(less flexibility; higher ec. of scale)*	yes *(will encourage market integration)*

Preferred option

In practical terms, entity pooling in a broad sense would imply an important change to the UCITS Directive. Relaxing the diversification requirements of funds of funds structures could be seen as a challenge to the principles underpinning the Directive. In addition, entity pooling in a broad sense has not yet been widely tested at national level and both regulators and a number of industry players seem wary about it[126]. The preferred option is therefore option 2 (master-feeder structures). Its potential for savings is higher and investor protection impacts are lesser.

126 Support for master-feeders structures have been generally higher than for entity pooling in a broad sense. Please see responses to the Expert Group report on Market Efficiency and to the exposure draft consultation.

However, implementing master-feeder structures will still require setting a series of requirements (including information obligations) in order to minimise any potential supervisory concerns. Most of those are summarised in the tables of the 'Design of the framework' section. An effective co-operation mechanism between regulators would also be required in order to overcome potential investor protection concerns in the case of cross-border structures.

Other (general) considerations

There exist close interlinkages between this and other of the issues analysed in this report. First of all, clear and meaningful disclosures would enhance investors' understanding of the implications of the pooling structure. Particularly attention should be given in the Key Investor Information to the resulting investment policy and the global costs to be borne by the investor. Additionally, the savings potential of cross-border master-feeders could be boosted if an effective management company passport would be in place. Finally, the relation with fund mergers, already explained in the fund mergers' fiche.

Impact table

Option	Affected parties	Effect Direct: D Indirect: I	Impacts Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Impact Timing One-off Short-term Medium-term Long-term On-going	Impact Nature Dynamic Static	Impact Likelihood Certain High Medium Low
Entity pooling in a broad sense	Industry	D	++ (product innovation flexibility)	on-going	dynamic	high
			+ (scale savings)			
			- - (more complex monitoring/administ.)			low
	Investors	D	++ (greater fund choice)	on-going	dynamic	high
		D/I	≈/- (lower protection)			
			+ (lower costs)			medium
	Regulators	D	- (more resources needed)	on-going	static	medium
Master-feeders	Industry	D	+ (product innovation flexibility)	on-going	dynamic	high
			++ (scale savings)			
			≈ (more complex monitoring/administ.)			low
	Investors	D	+ (greater fund choice)	on-going	dynamic	high
		D/I	≈ (lower protection)			low
			+ (lower costs)			high
	Regulators	D	+ (less supervisory concerns/resources)	on-going	static	high

Virtual pooling

Virtual pooling uses information technology to commingle the assets of two or more funds in a virtual investment pool. This technique is extensively used in some MS, such as Ireland[127]. However, to achieve its full savings potential, some parts of the industry are asking for the freedom to pool fund assets across borders (No cases of cross-border virtual pooling have been accounted for so far.)

Advantages

As indicated above, virtual pooling achieves savings at three levels: front-office, middle and back-office and on trading desks. Vis-à-vis entity pooling, since the pool is not a fund, the costs associated to the establishment and maintenance of that 'master' fund are not incurred.

Disadvantages

Virtual pooling relies on efficient accounting systems capable of identifying at any time the assets of each participating fund. This often implies investment in complex IT systems. Part of the economic advantages of virtual pooling could be thus initially foiled. Overtime, the cost of virtual pools is considered to be limited[128].

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

Barriers

Virtual pooling structures are not prohibited by the UCITS Directive. However, the absence of a common understanding among regulators hinders its cross-border development. Further hurdles are related to the restrictions to delegate cross-border the safe-keeping of assets. Tax barriers are in general not considered to be an insurmountable problem[129].

Conclusion

No legislative change is required in order to create a pan-European framework for virtual pooling. Nothing in the Directive impedes the use of this pooling technique. The question therefore is whether the Commission should take any measure in order to create a facilitating environment for virtual pooling. However, the analysis carried out does not find at this stage sufficient grounds to justify such measures. Savings appear to be less straightforward than for other pooling techniques, such as master-feeder structures. Important cross-liability and other investor protection concerns exist. The use of the technique is rare outside a few MS and no experience with cross-border virtual pooling has been identified so far. Industry responses to

[127] Allowed by the Irish regulator since 2004.

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

[129] Please see the report referred to in footnote 98.

consultations show a clear preference for entity over virtual pooling techniques. Analysis of the issues blocking the cross-border development of virtual pooling should be first discussed in appropriate fora, e.g. CESR (as recommended by the expert group on market efficiency).

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

Management Company Passport

Problem description

The 1985 UCITS Directive introduced a passport for the product, the investment fund. This implied that once authorised in a MS, a UCITS fund could be marketed in other MS following a simple notification (to the host MS authorities). The management company (MC) had no comparable right to provide collective portfolio management services directly to UCITS funds domiciled in another MS. The management company needed to be formally established in the domicile of the fund. However, over the years, centres of excellence have developed in some parts of the EU (based on the delegation of activities by the appointed MC in the fund domicile to other operators). Investment management activities are typically carried out in London, Paris or Frankfurt and fund administration activities in Luxembourg and Dublin. This concentration trend has led to important advantages in terms of economies of scale and of know-how.

Amendments made to the UCITS Directive in 2001 (also called UCITS III amendments) introduced important changes in respect of management companies[130]. One of the main objectives was to up-date the regulation for MC, aligning it with that existing for other operators in the financial services area[131]. These amendments sought to introduce a management company passport, i.e. the possibility for a MC to manage a UCITS (of a corporate form[132]) based in another MS. In parallel, new provisions on minimum capital requirements for the MC, increased risk control obligations and cooperation mechanisms between supervisors were also introduced.

Implementation of the management company passport provisions has encountered difficulties. They were insufficiently clear. Commission services recognised this problem in the Green Paper on investment funds. The main concern has been that the subsequent split of supervision (between the fund supervisor and the MC one). Supervisory gaps risked undermining investor protection[133]. National regulators consider that the legal/supervisory conditions do not exist to allow cross-border fund management to take place under appropriate safeguards for investors and sound risk management. The respective roles and responsibilities of the competent authority for the fund and for the MC were not specified by the 2001 amendments; creating uncertainty over the monitory and compliance of UCITS rules. No attention was given to the conditions needed to ensure effective information flows

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130 Amending Directive 2001/107/EC of 21st January 2002 also called the "Management Company Directive"

131 Explanatory Memorandum of the "Proposal for an European Parliament and Council Directive amending Directive 85/611/EEC", COM(1998) 451 final, 17th July 1998.

132 'Corporate UCITS' or investment companies are UCITS constituted under statute. They generally have a Board of directors and investors (shareholders) can be entitled to vote in general assemblies. Corporate UCITS have a legal personality. On the other hand, 'contractual UCITS' are constituted under the law of contract (common funds) or trust law (unit trusts). They do not have a legal personality.

133 The UCITS would be supervised by the authority of its home Member State whereas the management company would be under the supervision of another Member State authority. If the UCITS does not comply with the rules of its home Member State the supervisory authority responsible for it would have therefore no legal means to call directly to account the management company located in another jurisdiction.

between fund depositary and MC. The modalities for cooperation between national authorities and enforcement in the context of cross-border fund management were not addressed.

In 2005, CESR concluded that "… the legislator's intention does not seem to have been to impose to UCITS home Member States to recognise the possibility for a foreign management company to set up a [corporate UCITS] in their own constituency"[134]. The passport would, according to CESR, be possible for the article 5.3 services (i.e. individual portfolio management, investment advice and safekeeping and administration). As shown in the WPIA, the possibility to passport those ancillary services have been exploited to a limited extent by European management companies (only some 10% of the total number of management companies). According to the Expert Group on market efficiency, this low take-up was the proof of a mismatch between the passporting services available and the flexibility that the industry really needed.

In the absence of a working management company passport, fund promoters have to establish management companies in all countries in which they set up fund ranges. Then, they will quite often delegate portfolio/asset management to an entity typically based in one of the European investment management centres. This not only results in a duplication of resources[135] but also impedes the industry from benefiting from greater specialisation and economies of scale. UCITS III "substance" requirements (minimum capital, at least two persons conducting the management company's business…) are said to considerably exacerbate the situation. According to EFAMA, the fully-loaded costs of a management company in an EU jurisdiction are approximately € 1 million a year. The Expert Group on IFME considered that "the establishment and maintenance of a UCITS III management company in an 'exporting' country can cost between € 500,000 and € 1 million". Hiring a third party to act as local MC is also expensive[136]. Cost are thus pushed up and charged to the fund and its investors. The fact that the original passport was limited to funds of a corporate type also reduces the potential benefits of the passport. Funds of a contractual form are the most common type of fund in 18 MS and the only existing type of fund in 13 of them.

Consequently, the WP announced that the Commission would revisit this issue in order to see if the MC passport could be rendered operational through changes to the relevant provisions of the Directive. However, it emphasised that a precondition for a management company passport would be that both the MC and the fund were subject to effective and coordinate oversight. The ambiguities and legal uncertainty that had undermined the 2001 passport provisions would need to be tackled by the introduction of effective provisions. The exposure draft submitted to consultation in March 2007 tried to strike a balance between a comprehensive MC passport and supervisory concerns. The proposed (partial passport) framework included provisions to ensure a minimum of substance in the fund domicile (indicating the functions that should remain in that MS so as to provide the fund authority with direct control over some core administrative functions and a basis on which to monitor and enforce compliance). It also aimed at enhancing supervisors' cooperation mechanisms.

[134] "CESR guidelines for supervisors regarding the transitional provisions of the amending UCITS Directives (2001/107/EC and 2001/108/EC)", February 2005.

[135] This would typically include the costs related to the staff and premises, administration and legal costs, as well as the cost of capital.

[136] In its response to the Green Paper consultation, Goldman Sachs Asset Management stated that engaging the services of a third party management company for its Irish and Luxembourg ranges would amount to € 4.4 million annually. Also IMA, in its response, reports costs of € 750,000/annum to rent a management company to oversee a simple structure and € 1,5000,000/annum for an umbrella structure.

The exposure draft proposals envisaged that the fund domicile would be determined against two criteria: 1) the country under whose laws the fund is constituted and 2) where the verification of the fund valuation and the maintenance of the unit-holders' register take place. The passport would be also extended to funds of a contractual type. The depositary would remain based in the fund domicile.

Responses to the Exposure Draft consultation

Scope of the passport: A majority of respondents (mainly industry players) considered that management companies should be able to provide the full range of portfolio management and fund administration activities on a cross-border basis. They argued that only a full passport would enable real economies of scale and lead to the establishment of centres of excellence. This would increase the quality of customer service and risk management. Supporters of the exposure draft's approach considered that some administrative substance must be located in the fund domicile in order to allow the competent authority of the fund to discharge its responsibilities for ensuring that the fund is operated in accordance with EU and national fund rules.

Extending the passport to contractual funds: A number of respondents questioned the viability of the management company passport in the case of contractual funds. (As contractual funds have no legal personality distinct from the management company, it is difficult to distinguish between MC and fund for legal or supervisory purposes).

Regulatory responsibilities and effective cross-border supervision. Several respondents pointed out that split supervision was a fact of life in an integrated financial services market and would have to be dealt with whatever the scope of the passport. However, a number of respondents (including a majority of regulators) considered that regulators' respective responsibilities should be further clarified. Most stakeholders were of the opinion that enhanced supervisors' co-operation mechanisms together with the presence of a depositary in the fund's domicile should prove sufficient to ensure proper seamless supervision of fund and MC. Many respondents underlined the important role of CESR in enhancing supervisory co-operation and solving potential problems with regards to split supervision.

Safeguarding investor interests: Some contributors claimed that a full passport might be a superior solution from an investor protection perspective because it would permit integrated supervision and risk management. Other respondents were concerned that split supervision between UCITS and management company home Member States could compromise investor protection. Some respondents were concerned that expected cost savings would materialise only very gradually for investors.

Definition of UCITS fund domicile. Most respondents proposed to define the fund domicile by reference to the applicable law. Many contributors challenged the proposal that "verification of valuation and pricing" and "maintenance of unitholders' register" were core administrative functions which needed to be performed in the fund domicile. Conversely, some contributors believed that if all management functions were performed on a remote basis, 'letter-box' entities would result; with consequent dangers in terms of less effective enforcement of fund rules.

Depositary. The majority of respondents agreed that the depositary should continue to be located in the same MS as the fund. Some replies indicated that a deeper specification of the responsibilities of the fund depositary could be one means to help supervision by the fund's competent authorities.

Taxation. Several respondents raised this issue. Many of them considered that the potential negative tax consequences of the full passport had been overstated. No tax complications were identifiable for corporate funds or the most successful (fiscally transparent) contractual funds.

Objectives

An enhanced legislative framework for the management company passport should properly address the different stakeholders' concerns and realise their expectations. This framework should therefore:

a) from a single market perspective:

- Encourage cross-border activity driven by efficiency gains and competition
- Facilitate the development of (fund management and administration) centres of excellence [and thus encourage scale savings and specialisation gains]

b) from an industry angle:

- Allow market participants to organise their business models on a cross-border basis in line with commercial priorities
- Facilitate the reaping of specialisation and economies of scale related savings
- Create the minimum (administrative) burden

c) from the regulators' point of view:

- Allow regulators to fulfil their supervision and investor protection duties
- Be clear as regards regulators' respective responsibilities

d) as well as, ensure that investors:

- Have access to the best asset management teams
- Are adequately protected

Benefits

The main benefits of an effective management company passport would be the following:

	For investors	For the industry
Short-term	*(no or limited effect)*	possibly lower costs
Long-term	possibly lower costs	More business opportunities; lower costs

Costs savings and specialisation gains will materialise slowly over the short to medium-term. Duplicated costs will be eliminated progressively (notably minimum capital requirements and other costs linked to the establishment of the management company). Fund management and administration functions will move to the most cost-effective locations, where competition among related services providers should intensify. This competition may encourage savings to flow gradually up to the investor level. In the long-term, the passport could encourage fund promoters to establish fund ranges in a larger number of domiciles. Lower costs and greater business opportunities should have a positive effect on the development of the European fund market over the long run.

Redesign of a framework for the management company passport

The early debate over the scope of the MC passport has been driven by commercial considerations. Concerns regarding the supervisory and regulatory challenges posed by remote fund management were not initially at the front of discussions. In the light of concerns expressed by some stakeholders (including a large number of regulators) in response to the exposure draft, the Commission services have adopted a risk-based approach to the design of a possible MC passport. This involved a systematic approach to identify:

a) which risk controls should apply at the level of the MC and which at the level of the fund;

b) the mechanisms and conditions needed to ensure that fund administrators overseers could ensure the sound day-to-day function of the fund in accordance with its rules;

c) mechanisms to create effective and timely information flows between the respective national authorities to ensure that the authority responsible for the fund is:

- satisfied with the risk management controls used by the MC (in other MS)
- confident that it has means to monitor the functioning of the fund in an on-going basis, to detect or avert breaches, to respond promptly in case of a problem and to employ effective remedies.

The options that will be analysed are the following:

1) Maintain the status quo (i.e. do nothing)

2) Make the MC passport work for corporate funds and extend it to contractual funds

3) Make the MC passport work for corporate funds

Impacts analysis

Option 1: Do nothing

Impacts from the point of view of:

(Since the main implications of this option have been already explained in the problem description part, the following analysis will highlight only the most important ones.)

a) **Industry**: This will be seen as an important missed opportunity by the fund industry. While direct annual savings are relatively modest (the WPIA estimated potential cost savings of € 381 to € 762 million/year), the medium to long-term implications are considered important by the industry. The current lack of flexibility in organising the different activities of the fund value-chain hinders the industry development by impeding the exploitation of scale and specialisation gains.

b) **Investors**: They will continue to bear the indirect consequences of the lack of organisational flexibility: higher fees. It has also been argued that current (asset management) delegation agreements render risk controls more difficult (increasing therefore operational risks) to the detriment of investors.

c) **Regulators**: Maintaining the status quo will give regulators comfort as to their ability to effectively ensure the supervision of funds under their jurisdiction. Otherwise, no relevant impact on regulatory authorities is to be expected if the current situation continues.

Option 2: A working MC passport for corporate funds and contractual funds

Impacts from the point of view of:

a) **Industry**: This is the option that could in principle maximise the gains from the passport (please see the estimated savings figure indicated in the problem description part) and the one most widely supported by industry players[137]. However, implementation of this option would require reinforcing the capacity of the regulator to supervise the remote-managed fund as explained above. This would most probably require additional reporting and other obligations on the side of the concerned fund's management company and/or the depositary, which could partly offset the passport's expected savings.

b) **Investors**: Main benefits for investors will derive from the centralisation of the risk management and the specialisation gains that the passport should encourage. These would increase the quality of products and could reduce operational risks. In case of costs savings, this could flow on gradually towards investors. This outcome depends on sufficient competition in fund management leading to savings being reflected in the fees paid by investors.

c) **Regulators**: National regulators have often expressed concerns about the risk that split supervision (between the fund regulator and the MC regulator) would be detrimental to the effective protection of investors. A clear definition of the roles and responsibilities of each regulator has repeatedly being mentioned as the 'sine qua non' condition for the acceptance of the management company passport[138]. In order to avoid potential supervisory gaps (or overlaps), this clarification should be provided at level 1 (i.e. at the Directive level). Both authorities should have the means to monitor and enforce rules under their responsibility. It will be also necessary to provide for effective information exchanges and other cooperation mechanisms in order to allow both the fund and the MC regulator to properly carry out their supervision tasks. Although, some cooperation and information obligations already exist in the Directive these will need to be reinforced in order to overcome regulators' reluctance to the passport. This would clearly imply greater costs for the regulators. The design of the

137 Previously expressed fears that the scope for savings would be reduced due to greater costs on the side of the depositary (which will have to monitor a management company from another MS) were broadly dismissed by respondents to the exposure draft consultation, which considered that the 'physical presence' of the depositary in the country of the MC was not necessary given modern electronic means.

138 The fact that the depositary remains in the fund's domicile should also provide comfort to regulators.

relevant provisions appears also a difficult task considering the current lack of consensus of national regulators on this issue.

Another important issue to be taken into account is the following. Contrary to corporate funds, contractual funds lack legal personality. In their case, the MC is the entity that represents legally the fund. (In fact, some see the contractual UCITS and its MC as an indivisible whole[139].) The problem is therefore that the fund and its MC can not be easily distinguished for legal or supervisory/enforcement purposes.

This presents the following problems from the perspective of the MC passport:

1) the fundamental difficulty of identifying a fund domicile which is different from that of the MC (given that the fund is part of the same legal personality as the MC and that location generally is defined by reference to the country where the MC's head office is based)

2) if a solution to 1) can be found, the fund supervisor may not have a legally accountable entity in its jurisdiction to whom it can address questions regarding compliance or pursue enforcement actions in the event of a breach of the law[140].

Despite a careful analysis of these problems, expert groups and detailed research have not identified effective solutions.

During the exposure draft consultation, some respondents raised an issue that deserves also to be considered. This is the potential tax implications of the passport. A number (even if small) of respondents considered that the passport would lead to a double taxation of the fund that would cancel out the savings achieved by the passport. If this is so, efforts to fix the management company passport would be vain.

The rationale behind this is the following[141]: since the effective management of the fund takes place in the country of the MC (e.g. country A) it could be considered that the fund which it manages is also a tax resident in that country. If this scenario materialises, the fund could then be subject to income and operating tax both in its country of domicile (country B) and the country of its MC (country A); thus, cancelling out all or part of the benefits of the MC passport. While some respondents to the exposure draft considered the risk of double taxation small, this eventuality cannot be ignored.

Option 3: A working MC passport for corporate funds

<u>Impacts from the point of view of</u>:

a) **Industry**: This will still be a step forward for the industry that would be able to make effective use of the business possibilities that the 2001 UCITS changes were supposed to bring about. However, the savings risk being sensibly smaller than the expected gains outlined above. Recent data provided by CESR shows that in 13 MS corporate UCITS do not exist. In those MS that have both corporate and contractual funds, the number of contractual funds

139 See for example the Finnish Ministry of Finance's response to the exposure draft consultation.

140 In the case of corporate funds, even if the MC would be abroad, there would remain another responsible body in the fund domicile. This is the Board of directors which is accountable to the fund's regulator.

141 Please see the Association of the Luxembourg Fund Industry (ALFI) response to the exposure draft consultation.

often exceeds that of corporate ones[142]. Again, as explained in option 2, additional reporting and other obligations on industry's players would compensate part of the passport's expected savings.

b) **Investors**: The effect on investors would be similar to the one explained in option 2. However, given the lower number of funds concerned, the advantage for the investor risks to be limited.

c) **Regulators**: As explained above, concerns regarding split supervision could be overcome by establishing an appropriate clarification of responsibilities and an efficient cooperation mechanism. However, the impact in terms of additional burden for regulators should not be neglected considering that to overcome those concerns a reinforcement of the cooperation provisions in the Directive would be needed.

Other effects

SMEs: introduction of a working passport could have a positive impact on smaller asset management groups. These would be able to base fund ranges in a greater number of MS which were until now closed to them due to the costs associated to the required establishment of a fully fledged management company.

Summary table

	Specific Objectives			Overall Objective	
	Investor protection	Efficiency: administrative burden	Efficiency: sector efficiency	Pro Single Market?	Feasibility
Do nothing	+/- *(some operational risks)*	≈ *(status quo)*	- *(untapped savings)*	no *(barrier entry to service host market)*	*Not applicable*
Passport for all funds	-- *(concerns re. split supervision and contractual funds)*	-- *(burdensome procedure)*	++ *(lower costs; specialisation gains)*	yes *(will foster market integration)*	*Difficult (particularly re. contractual funds)*
Passport only for corporate funds	- *(split supervision concerns)*	-- *(burdensome procedure)*	+ *(some cost savings/ specialis. gains)*	yes *(will facilitate market integration)*	*Doubtful*

Preferred option

In line with the conclusions of the WPIA, the first option (i.e. do nothing) remains unsatisfactory. As summarised in the above table, this option is disappointing from all points

142 It needs however to be noted that in some important fund jurisdictions (in terms of assets under management) such as France, Luxembourg, Ireland or Spain both fund forms are extensively used.

of view (investor protection, single market and efficiency). However, the analysis carried out has not succeeded in proving the superiority of the other two options. In order to overcome supervision related concerns, a considerable reinforcement of the Directive's supervision mechanisms is necessary. This would entail, among others, additional obligations on industry's players and would inevitably lead to greater compliance costs. The possible form of those additional supervision safeguards have been studied in parallel to the preparation of this impact assessment. Despite efforts to simplify and limit any additional burden on the industry, this objective has not been possible to conciliate with the need to properly address split supervision concerns. As a result, the expected savings stemming from both options 2 and 3 risk being fairly inexistent (if any). In addition, given the substantial concerns expressed by supervisors since the management company passport debate was launched by the Green Paper, the task of developing a framework responding to all those concerns appears, at this stage, difficult. The current lack of consensus among regulators on this issue also renders this undertaking particularly challenging. Accordingly, a 'feasibility' column has been added to the above summary table. This column reflects our doubts regarding the possibility to give effect to the passport; either for corporate funds (option 3) or for both types of funds (option 2). In this last case, the technical difficulty of designing a solution that would be appropriate also for funds not having a legal personality distinct of that of their MC (contractual funds) renders this option even less feasible.

While this conclusion is disappointing (particularly given the efforts deployed since the Green Paper in order to find a solution), it does not mean that no further work should be pursued in this area. Since regulators are the better placed to assess the potential risks and supervisory gaps of the passport and to identify optimal cooperation mechanisms, continued dialogue with them will be needed. Considering that a number of CESR members believe that obstacles to efficient cooperation are not insurmountable, it should be possible to identify solutions that give full effectiveness to the MCP without jeopardising either investor protection or expected cost savings. (The intention to introduce in the legislative proposal provisions aiming to enhance supervisors' powers and cooperation should also encourage the finding of an optimal solution.)

Finally, it appears necessary to assess the impact of this recommendation on the other proposed measures. In particular, whether this risks unbalancing the effectiveness of the resulting legislative package. The answer is negative. Part of the rationalisation efforts aimed at by the MCP could be achieved by other means. First of all, a streamlined notification procedure will increase markets' openness and thus reduce the need to launch parallel fund ranges in different MS. A single fund range based in a single country (and therefore with a single MC) will be able to easily access investors in all MS. (This would particularly benefit smaller asset management groups.) Secondly, the possibility to merger funds across borders will reinforce this MC rationalisation process. By allowing the merger (and liquidation) of a fund established in country A into a fund in country B, industry players will be able to concentrate their fund ranges in the most efficient fund domiciles thus allowing the dismantling of MC in the less efficient ones.

On the negative side, the impossibility for feeder and master to have the same MC when domiciled in different jurisdictions will limit the expected savings of cross-border master-feeder structures. However, given the size of the expected economies of scale (compared to the MCP identified opportunity costs), the net impact of the introduction of a master-feeder framework remains clearly positive (even in the absence of a MCP).

Impact table

Option	Affected parties	Effect Direct: D Indirect: I	Impacts Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Impact Timing One-off Short-term Medium-term Long-term On-going	Impact Nature Dynamic Static	Impact Likelihood Certain High Medium Low
Do nothing	Industry	D	- (less organisational flexibility)	on-going	dynamic	certain
			-- (higher costs)			
	Investors	D/I	+/- (greater protection but operational risks)	on-going	dynamic	medium
		D	- (higher costs)			high
	Regulators	D	≈ (no significant impact)	on-going	static	high
Passport for all funds	Industry	D	+ + (highest organisational flexibility)	on-going	dynamic	certain
			≈ (highest savings but risk that cancelled out by administ. costs)	medium-term		high
	Investors	D	-- (lower protection)	on-going	static	medium
		I	+ (lower costs)	long-term	dynamic	medium
	Regulators	D	-- (supervisory concerns)	on-going	static	high
Passport only for corporate funds	Industry	D	+ (organisational flexibility)	on-going	dynamic	certain
		D	- (lower cost savings but risk that outweighed by administ. costs)	medium-term		high
	Investors	D	- (lower protection)	on-going	static	low
		I	? (lower costs)	long-term	dynamic	low
	Regulators	D	- (lower supervisory concerns)	on-going	static	high

Simplified Prospectus/Key investor information

Problem description

Taking into consideration information asymmetry concerns, the original UCITS Directive introduced a series of disclosures obligations in 1985. This included the obligation to publish a prospectus. This would contain "the information necessary for investors to be able to make an informed judgment of the investment proposed to them"[143]. However, the prospectus contained too much detailed information to be able to effectively fulfil this task. It was considered that such information did "not fit well into the needs of the average investor and that investor protection can be achieved more effectively through the provision of clear, simple and essential information"[144]. UCITS III amendments[145] therefore introduced the concept of simplified prospectus.

The objective of the simplified prospectus (SP) was to provide investors with a really useful tool on which to base their investment decisions. It was designed to provide clear and easily understandable information about the essentials the investor should know before investing in a fund. A schedule annexed to the UCITS Directive listed the key items that the SP needed to contain. The SP was also intended to facilitate the cross-border marketing of UCITS by constituting a single (and therefore comparable) marketing tool throughout the Community. UCITS were required to offer it to investors free of charge before the conclusion of the subscription contract. In order to clarify the contents and the presentation of some of the required information items, the Commission's adopted a Recommendation[146] in 2004.

However, the SP exercise turned out to be disappointing for both industry and investors. An inconsistent implementation of the Recommendation has undermined the comparability of the SP across MS. Changes to the SP required by host MS regulators during the notification procedure have created new barriers to the cross-border offering of UCITS; limiting thus the choice available to investors. Adapting the SP to those required changes has also considerably increased the costs for the industry that has to prepare tailor-made national versions. Finally, uncertainties about the liability attached to the SP have driven the industry to include additional information and legal disclaimers creating long and elaborate documents.

As a result, investors are most often provided with a complex set of incomprehensible information that is of little use to them. The fund industry is burdened with inconsistent requirements and unnecessary costs. A respondent to the exposure draft consultation estimated at € 1 million its annual expense for the translation and printing of investor disclosures[147]. Dutch data regarding the obligation to produce disclosures shows that the annual cost for the industry is more than € 4 million. Considering that Dutch funds represent a

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143 "Toward an European market for UCITS", Commentary on the provisions of Council Directive 85/611/ECC, European Commission (also called Vandamme report)

144 Explanatory memorandum of the "Proposal for a European Parliament and Council directive amending the UCITS Directive" of 17th July 1998, COM (1998) 451 final.

145 Directive 2001/107/EC of the European Parliament and of the Council amending the UCITS Directive.

146 Commission Recommendation 2004/384/EC of 27 April 2004 on some contents of the simplified prospectus as provided for in Schedule C of Annex I to Council Directive 85/611/EEC; hereafter referred to as "the recommendation".

147 Please see BlackRock response to the exposure draft consultation.

small fraction of the total number of European investment funds[148], the costs for the whole European industry are not negligible.

These costs are eventually passed on to investors. This hinders the ability of UCITS to compete with other comparable investment products. Most often these competing products (e.g. certificates, unit-linked insurance contracts) are subject to less restrictive information requirements and are, therefore, cheaper to produce and easier to place in the market.

In order to push forward the debate on the SP and to identify ways to improve it, the Commission organised in 2006 two workshops with representatives of all stakeholders (regulators, investors and industry). The box below summarises their main conclusions.

Simplified Prospectus Workshop's conclusions

♦ Target public: the SP should be addressed to retail investors.

♦ Structure/ format: the SP should be a short document in the form of a "fact sheet"; a maximum length should be imposed. The use of graphics should be further considered.

♦ Content: the SP should provide key information to the retail investor, enabling it to make an informed investment decision.

♦ Translation requirements: the SP should be available in the national language(s).

♦ Role of home/ host state regulator: once filed with the home state regulator, the host MS regulator cannot require any additional elements to be added to the SP.

♦ Respective roles of fund promoter and distributor: the fund promoter should be responsible for all product related disclosures, the distributor for other disclosures.

In addition to the above-mentioned drawbacks, the UCITS Directive current provisions on the SP do not take into account practical aspects such as a) the different distribution channels through which UCITS are offered to investors; b) the possibilities offered by modern (electronic) transmission methods; c) the professional or retail nature of investors.

The WPIA considered that changes to the Recommendation would be the quickest way to improve the situation. However, given the non-binding character of the Recommendation, it concluded that efforts risked being unfruitful. Hence, the WPIA ultimately proposed changing the UCITS Directive itself.

On that basis, the exposure draft presented a completely new approach to investors' disclosures: the key investor information (KII) concept. It put forward the idea of a fair, clear and not misleading set of information, not necessarily embodied in a specific document. KII would include all the product information relevant for the investor to assist him/her in taking an informed investment decision, as well as practical information necessary for the investor to be able to exercise his/her rights. It suggested that such information could differ according the professional or retail nature of the investor. The exposure draft proposed delivery obligations

[148] Dutch funds represent just 1.3% of the total number of European funds (i.e. UCITS and non-UCITS). EFAMA data end 2005

in line with the different distribution models used. It also suggested to limit liability to the cases where the KII was misleading, inaccurate or inconsistent with the full prospectus.

As recommended by the WPIA, the planned changes to the UCITS Directive (Level 1) would concentrate in defining the high-level principles of the KII (purpose and main characteristics). The detailed provisions about the content and format of the KII will be designed in Level 2 measures. This will ensure that, once new measures are agreed, they will be implemented consistently by MS, thus avoiding previous failures and achieving finally the objective of comparability between funds marketed cross-border.

Giving consideration to the urgency to remedy the past failures of the SP, the Commission deemed it desirable to start straight away some ground work on the detailed provisions content and format of the KII. This would ensure that some of the critical issues could be considered at the same time as work is progressing at Level 1. The Commission has accordingly made a request to CESR for assistance[149]. A sub-group of the CESR Investment Management Expert Group has been formed to consider the detailed content and form of KII[150]. CESR has been requested to provide the Commission with its recommendations and advice in early 2008. CESR advice will be based on extensive dialogue with stakeholders and consultation.

The Commission has also undertaken to carry out consumer and market testing before KII is introduced. The objective is to ensure that KII represents a sufficient improvement to existing investor disclosures in order to justify the costs that firms will incur in replacing the SP. The testing will be done on the basis of examples on the content and form of KII developed by the CESR KII sub-group, as put forward by CESR in its advice to the Commission. In order to undertake this testing, the Commission is launching a study which is to start in early 2008.

Responses to the Exposure Draft consultation

General concept. The proposed approach to replace the current SP by 'key investor information' was generally welcomed by stakeholders. KII should be a short, simple document conveying key facts to retail investors in a clear and understandable manner so as to assist them in taking an investment decision. Its target public primarily is the retail investor. It should be possible to use KII on a EU-wide basis without further modification.

Content. A majority of stakeholders called for the fullest possible harmonisation of individual disclosure items to be included in KII. Many respondents also insisted that KII should contain only product information and no distribution related items. Various respondents stressed the need for consumer/market testing to ensure that the disclosures are relevant and meaningful for investors.

Format. Many stakeholders stated their preference for a single document as opposed to using a more flexible approach whereby key investor information could be included in other disclosure/marketing documents depending on the sales channels used. They considered the single document to be the most cost-effective solution. A single document would also help investors to compare UCITS. Some respondents welcomed a more flexible approach allowing

149 "Request for assistance on detailed content and form of key investor disclosures for UCITS", 11th April 2007 (published on CESR website).

150 The sub-group is jointly chaired by the UK FSA and the French AMF and includes representatives of eight other MS.

distributors to include KII in other documents. They considered that distributors should retain discretion on how to convey key investor information to the end-investor and that MiFID imposes stringent requirements on distributors in this regard.

Other issues. Most respondents favoured allowing electronic delivery of KII and the use hyperlinks. Some respondents considered that the content of KII could vary as a function of the retail or professional nature of investors. However, most respondents saw little advantage in such differentiation. As regards to its liability, most respondents supported the envisaged limitation of liability attached for KII. Proposals regarding the language regime were welcomed since they were seen as leading to a considerable reduction of costs. However, some respondents expressed concerns regarding the fact that other mandatory disclosures (full prospectus, annual reports) would not be translated.

Objectives

The new provisions on investors' disclosures should:

a) from a single market perspective:

- Clearly indicate that host authorities do not have the power to request changes to KII (what would simplify the notification procedure and therefore facilitate the placing into the host market of foreign funds)
- Allow for comparability between funds (what should encourage competition and thus put pressure on costs)

b) from an industry angle:

- Create the minimum (administrative) burden
- Provide some flexibility
- Clarify industry's (production and delivery) obligations and liability issues

c) from the regulators' point of view:

- Allow an adequate supervision
- Ensure that the interests of investors are adequately protected

d) as well as, ensure that investors:

- Have all the necessary information to take an investment decision
- Can compare among funds

Benefits

The main benefits of the new investors' disclosures requirements would be:

	For investors	For the industry
Short-term	Better quality disclosures (i.e. enhanced protection)	Small cost savings (due to adjustment costs)
Long-term	A share of costs savings	Important cost savings

Better disclosures will considerably increase the ability of investors to take informed investment decisions, enhancing thus investor protection. Over the long-term, particularly if improved transparency and comparability encourages competition, part of the savings will be passed on to investors (e.g. in the form of lower fees or higher performances). For the industry, savings would also not materialise immediately. Adjustment costs will compensate in the short-term part of the savings derived from the simplified disclosures.

Design of a framework for investors' disclosures

In line with the conclusions of the simplified prospectus workshops and the responses to the exposure draft consultation, the KII should have the following main features:

- Be clear, short and easy to understand for retail investors
- Be provided in the official language(s) of the investor's MS
- Be kept up-to-date.

However, regarding other aspects of the new disclosures several possibilities exist. The following table presents (in bold and italics) the preferred choices.

Relevant aspects	Possibilities	Comments
Delivery method	Only on paper Only by electronic means At the choice of the fund provider or distributor ***At the choice of the investor***	Important savings are anticipated if fund providers would be allowed to deliver KII only in an electronic format[151]. However, this would most probably not provide an adequate level of investor protection. Some voices point out that both hard-copy and electronic delivery should be required to assure that any potential investor gets the information s/he needs[152] Others defend that the basic delivery form should be a physical document and that electronic delivery should only be possible on request[153]. The most appropriate solution appears then to allow different delivery possibilities but to let the choice to the actor most apt to assess the suitability of each delivery method: the investor.

Relevant aspects	Possibilities	Comments

151 For instance, BlackRock in its response to the exposure draft consultation considered that many hundreds of thousand euros per annum could be saved if they were to provide only electronic KII and only to retail investors.

152 Please see Test-achats response to the exposure draft consultation.

153 Please see the Austrian Association of Investment Fund Management Companies (VÖIG) response to the exposure draft consultation.

KII content	***The same for all investors***	The exposure draft launched a debate on whether a distinction should be made depending on the retail or professional nature of the investor. During the consultation, some industry players argued that professional investors have different information needs than retail investors[154]. Allowing the contents of the KII to be tailored to the nature of the investor would provide him/her with more suitable information but could increase the administrative burden for the industry[155]. On the other hand, considering that UCITS are defined as a retail product under the UCITS Directive, introducing the possibility of a different treatment for professional investors could introduce some legal complexity and uncertainty.
	Adapted to the type of the investor	
Liability	Full liability	Uncertainties about the exact liability attached to the SP are one of the reasons why the SP has often become a legalistic document full of disclaimers and therefore complex and of little use to retail investors. Imposing a full liability regime will not improve this situation. A clear and limited liability regime, as proposed in the exposure draft, seems a more proportionate way forward. This has received a wide support, including from some investors' representatives (e.g. FIN-USE, FAIDER) that consider this as a fair compromise.
	Limited liability	

Impacts analysis

Support to the KII exposure draft's proposals during the consultation period was wide. Nevertheless, respondents expressed different views regarding the fact that the proposal did not require the KII to be presented in a single document. The following analysis therefore concentrates on the form of the KII. The two options identified are:

Option 1: Standardised key investor information provided in the form of building blocks not necessarily embodied in one single document

This would imply the possibility of 'slicing' the KII and present different parts of it in different documents.

Option 2: Standardised key investor information provided as a single stand-alone document

The KII would be presented as an indivisible set of information embodied in a single document.

154 Some respondents even asked for an outright exemption of the KII delivery obligation when UCITS were marketed to professional investors.

155 Some savings could be done however in the case of UCITS marketed exclusively to professional investors (such as certain money market funds).

Option 1: 'Building block' approach

Impacts from the point of view of:

a) **Industry**: The building block approach would allow greater flexibility regarding the presentation of the information. It would be possible to better adapt disclosures to the type of investor and/or to the distribution channels and methods used. (In fact, it can be argued that firms are better placed to decide how the information is most effectively presented to investors[156].) This approach would give distributors the possibility to add more easily commercial or distribution related information. It could also be helpful for distributors offering UCITS 'wrapped' in other products (e.g. fund of funds, unit-linked insurance contracts, structured notes…) On the other hand, replacing the current simplified prospectus by this new approach to disclosures would entail most possibly important adjustment costs in the short-term. On the long run, savings derived from the fact that the information is standardised (and not subject to changes, as recommended above) might be compensated by the additional costs of producing different (tailor-made) documents[157].

b) **Investors**: Key information would be spread over different documents. It would be therefore more difficult for investors to have a global picture of the investment proposed to them and to understand all its implications. Comparing products would be also fairly difficult[158]. On the other hand, the information might be better adapted to his/her concrete needs and situation.

c) **Regulators**: Some supervision concerns might emerge with this approach. It would be actually more difficult to check that investors receive all the KII if this is spread over different documents. This approach could also increase the administrative burden (for both regulators and industry) of the notification procedure[159].

Option 2: Single document

Impacts from the point of view of:

a) **Industry**: Some market players think that it is not the SP that has been a failure but the divergent way in which different MS have implemented the Recommendation and the relevant Directive provisions. They therefore support maintaining the SP/KII in the form of a single stand-alone document. Some respondents to the consultation recommended using the model developed in 2002 by the industry (FEFSI, now EFAMA). They consider it a less

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156 On the right for distributors to decide how to disseminate investor information please see the responses to the exposure draft consultation of Associazione Bancaria Italiana, European Banking Federation, Investment Management Association or the UK authorities.

157 Please see, for example, the response of the Czech Ministry of Finance to the exposure draft consultation.

158 In fact, the need to ensure comparability between funds was one of the most recurrent recommendations stemming from exposure draft consultation. This not only originated from investors' organisations responses (such as FIN-USE, Verbraucherzentrale Bundesverband), industry players and associations also shared that view (e.g. EFAMA, State Street, Slovenian Investment Fund Association, European Association of Cooperative Banks…).

159 The SP/KII is one of the documents that need to be included in the notification file. If KII is not embodied in a specific document this may render the procedure more burdensome.

costly way forward[160]. In fact, the adjustment costs linked to this option would probably be less important since it would imply a less radical change vis-à-vis the current situation[161]. It is also believed that there will be a lower risk of regulatory interference (in particular in relation to the notification procedure), specially if the content of such single document is fully harmonised.

b) **Investors**: A single document would most probably be simpler to use by investors. It would be easier for them to understand and to assess the virtues/drawbacks of the fund if all the relevant (or key) information is provided together. Investors will be able to compare between products and therefore to chose the one more in line with their needs. This ability to compare should, in the medium term, encourage competition forces and therefore put pressure on prices (fees).

c) **Regulators**: There would be greater comfort on the side of regulators that investors actually receive all KII. Regulators should then be less reticent to allowing a smooth notification procedure. This should render the marketing in the national market of foreign funds easier. The choice of funds for national investors would thus increase (which should enhance competition and put pressure on costs).

<u>Other effects</u>

Impact on SMEs: some positive impact on small industry players (including SMEs) is to be expected, particularly under the second option. If the costs of producing disclosures are lower and the notification procedure is smoother, they could more easily exploit business opportunities in foreign markets where access was too costly. On the other hand, they will probably endure a more direct competition from the big foreign market players.

Administrative burden: Although the form and content of the new KII is still being worked out, the objective to produce a short and standardised document should significantly reduce the industry's administrative burden. Currently simplified prospectus' size can range from a couple of pages to several tens. The need to adapt it in line with sometimes quite different local requirements oblige fund promoters to produce national tailor-made disclosures. The possibility to use electronic transmission means should also have an important positive impact.

Environmental impact: both options aiming to reduce the information provided to investor to 'key' items (and allowing electronic delivery), they should have a positive environmental impact (particularly the second option). This, however, would be negligible in relation to the importance of existing environmental challenges.

<u>Other (general) considerations</u>

The close interrelation of the KII with the notification procedure is clearly shown in the analysis above. As expressed by many respondents to the exposure draft consultation, a fully harmonised KII contained in a single document would very much facilitate the notification procedure. However, the KII is also interlinked with other measures analysed in other parts of

160 Please see, for example, the response of the Association Française de la Gestion to the exposure draft consultation.

161 Additionally, transitional provisions could be included in the legislative proposal in order to spread out those adjustment costs over a longer period.

this IA. For example, as regards to pooling, it is important that the KII be able to explain in clear terms the implications of the pooling structure's double investment layer. KII would also play an important role in fund mergers. A useful KII would help investors to compare the merging funds and more easily understand the implications of the merger on their particular case.

Summary table

	Specific Objectives			Overall Objective
	Investor protection	Efficiency: administrative burden	Efficiency: sector efficiency	Pro Single Market?
Building blocks	+/- *(adapted disclosures but no global view)*	- *(risk of higher burden)*	+/- *(more flexibility but risk of higher costs)*	no *(less comparability, could act as entry barrier to host markets)*
Single document	+ *(more user-friendly)*	+ *(lower costs and administrative burden)*	+ *(lower costs)*	yes *(comparability will encourage market integration)*

Preferred option

In view of the above analysis, and as shown in the summary table, the second option, i.e. presenting KII in a single stand-alone document, appears to be the option that complies better with the objectives of investor protection and efficiency. Since it will allow a greater comparison among different MS funds, it should also encourage the integration of the European fund market. A more detailed 'impact table' is also provided below.

Impact table

Option	**Affected parties**	**Effect** Direct: D Indirect: I	**Impacts** Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	**Impact Timing** One-off Short-term Medium-term Long-term On-going	**Impact Nature** Dynamic Static	**Impact Likelihood** (Un)certain High Medium Low
Building blocks	Industry	D	+ (more flexibility)	medium-term	dynamic	certain
			- (↑ costs)			medium
	Investors	D	+ (better adapted disclosures)	long-term	dynamic	medium
			+/- (↓ protection)	medium-term		uncertain
	Regulators	D	- (more difficult supervision)	on-going	dynamic	medium
Single document	Industry	D	≈ (less flexibility)	short-term	dynamic	certain
			+ (lower costs)			high
			+ (more business opportunities)	medium-term		medium
	Investors	D	+ (lower costs)	long-term	dynamic	medium
			+ (↑ protection)	short-term		high
	Regulators	D	+ (easier supervision)	on-going	dynamic	medium