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COMMISSION STAFF WORKING DOCUMENT

IMPACT ASSESSMENT

Accompanying document to the

1. Draft Commission Directive implementing Directive 2009/65/EC of the European Parliament and of the Council as regards certain provisions concerning fund mergers, master-feeder structures and notification procedure;

2. Draft Commission Directive implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company;

3. Draft Commission Regulation implementing Directive 2009/65/EC of the European Parliament and of the Council as regards the form and content of the standard notification letter and UCITS attestation, the use of electronic communication between competent authorities for the purpose of notification, and procedures for on-the-spot verifications and investigations and the exchange of information between competent authorities;

4. Draft Commission Regulation implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website.

This report commits only the Commission's services involved in its preparation and does not prejudge the final form of any decision to be taken by the Commission.

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1. INTRODUCTION

This impact assessment assesses policy options related to implementing measures for the updated UCITS (Undertakings for Collective Investment in Transferable Securities) Directive, as adopted in July 2009 (2009/65/EC, also referred to as UCITS IV).[1]

The UCITS Directive contains the regulatory framework for retail funds at the European level, and lays the basis for a single market in these funds. The regulatory framework for UCITS has been considered largely successful in delivering an effectively functioning market for funds in the EU, including ensuring the effectiveness of this market for retail investors. UCITS are central to many European households' arrangements for long term savings. They give small investors easy access to professionally managed and diversified baskets of financial instruments at affordable costs.

At the end of 2009 the assets under management of UCITS funds were slightly above EUR 5 trillion[2] representing 75% of all investment funds assets in Europe. Total investment fund assets represented 55% of the European Union's GDP at end 2009 and about 10% of European Households financial assets. This highlights the important role played by investment funds in the European economy. UCITS' status as a global brand continued to boost net sales of cross-border funds outside Europe, especially in Asia.

Despite this broad success, UCITS IV changes were adopted to address a number of efficiency concerns, investor protection issues, and practical problems that have been identified in relation to the UCITS industry, which together threatened to limit the further development of the UCITS market. These problems emerged as UCITS began facing increased competition from other forms of financial products that were also being targeted at retail investors (e.g. unit-linked insurance products and retail structured products). In addition, competition from products originating within other jurisdictions had also started to grow.

Given these pressures, it was considered important to limit unnecessary costs and address challenges brought by fast moving innovation in financial markets, so as to ensure an effective level playing field between different products, whilst also working to ensure the continued development of a single market for UCITS – with attendant benefits for the industry, the functioning of the capital markets, and investors. It was also necessary that the standards of investor protection enshrined in the UCITS framework remained best-of-class.

In addition to the fundamental changes to the UCITS framework necessary to address these issues, it was also felt that further harmonisation of technical details is or may be necessary in certain areas, so the legal basis was laid for the development of more detailed implementing measures to reside at level 2 in the framework of the Lamfalussy procedure.[3] The updated Directive distinguishes between those areas in which the Commission is required to adopt such implementing measures, and those areas where the Commission has discretion. This impact assessment provides analysis of proposed measures in both these areas. It must be read alongside the impact assessments which preceded the adoption of the level 1

[1] OJ L 302, 17.11.2009, p. 32–96: http://eur-lex.europa.eu.

[2] EFAMA November 2009: http://www.efama.org/index.php?option=com_docman&task=doc_details&Itemid=-99&gid=1096.

[3] The Lamfalussy procedure is described in section 2 in Annex I. More details as to how the Lamfalussy regulatory approach is impacted by the newly proposed supervisory architecture in financial services can be found in section 6 in Annex I.

UCITS IV changes; those impact assessments provide the overall rationale for action in this area and the framework within which the scope and purpose of the implementing measures can be understood.[4]

Separately from the UCITS IV changes, the financial crisis has highlighted additional potential refinements to the UCITS framework that may be necessary. Observations on the crisis have therefore been incorporated into this impact analysis, and new objectives and measures identified in two areas: first, where failings or insufficient practices of UCITS funds and their fund managers were exposed; second, where changes in other areas of financial services regulation require matching changes for UCITS for level playing field reasons (notably these issues relate to risk management and remuneration). It is important to note however that the UCITS IV proposals already addressed certain key issues – such as investor protection – that have now risen to further prominence following the crisis.

The Treaty on the Functioning of the European Union (Lisbon Treaty) substantially modifies the framework for implementing powers conferred by the legislator upon the Commission. Article 290 lays down the rules for "delegated acts" and Article 291 for "implementing acts". These changes will not affect the proposed UCITS level 2 implementing measures since the UCITS Directive was adopted before the entry into force of the Treaty (1 December 2009). As a consequence, level 2 implementing measures will be adopted in accordance with the procedures laid down in the comitology Decision.[5]

For complete background information, please refer to section 1, Annex I.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

2.1. Procedural issues

The approach taken to developing the content of the implementing measures varied depending on the nature of the individual issues. In general, as will be set out in section 2.2, consultation with the Committee of European Securities Regulators (CESR) formed the backbone of the process of developing and analysing options for the content of the implementing measures. CESR was invited to consider the earlier impact assessment work and supporting external studies undertaken by the Commission fully in its work. In addition, CESR consulted widely on all its proposals; given the technical nature of many of the measures being considered, this process was proportionate for ensuring impacts could be adequately identified and assessed.

In certain specific areas it was clear that existing evidence would not be sufficient for assessing different options, and in addition, the impact for key stakeholders (the industry, investors and supervisors) of the different options might be materially significant. In particular, it was recognised that specific studies would be needed in relation to the development of detailed implementing measures in the area of pre-contractual information. This impact assessment relies on the outputs from these studies.[6]

2.1.1. Impact Assessment Steering Group

An Impact Assessment Steering Group was established in October 2009. Colleagues from Directorates General Competition, Economic and Financial Affairs, Enterprise and Industry, Health and Consumer

[4] Impact Assessment for the recast of Directive 85/611/EC is available at http://ec.europa.eu/internal_market/investment/docs/legal_texts/framework/ia_report_en.pdf.
Impact assessment for the White Paper on enhancing the single market framework for investment funds is available at http://ec.europa.eu/internal_market/investment/docs/legal_texts/whitepaper/impact_assessment_en.pdf.

[5] Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission.

[6] The chronology of the preparatory process that supports this impact assessment can be found in section 3, Annex I.

Protection, Internal Market and Services, Taxation and Customs Union, the Secretariat General and the Legal Service participated in the discussions.

The Group met 4 times ahead of the finalisation of this report. The comments received during the discussions were very useful and led to considerable improvements being made to the IA. Consensus was reached in the group on the proposed scope of the IA as well as the broad analysis of options and their relative rankings. The last meeting of the IASG took place on 13th January 2010.

2.1.2. *IAB opinion and remarks taken into account*

The IAB meeting to assess this impact assessment took place on 24 February 2010 and the IAB submitted its final opinion, accepting the impact assessment report on 26 February 2010 subject to certain additional changes and improvements being taken on board. The following major changes were implemented in this report to reflect the requests of the IAB:

- The nature of problems was explained more clearly with an explicit indication of their scale where necessary (in particular for issues 1 and 2 but also 4 and 5);

- Options were explained in more detail and where appropriate additional options were considered (in particular for issues 1, 4 and 5);

- More concrete evidence was added demonstrating the scale of the impact of preferred options. Compliance costs were estimated and administrative costs and related administrative burden[7] were identified and analysed in a more detailed manner;

- Adjustments to the annexes supporting the main report and the content of the report were made so as to eliminate duplications and ensure the report functioned better as a self-standing document.

2.2. Consultation of interested parties

2.2.1. *Consultation of the Committee of European Securities Regulators (CESR))*

Within the Lamfalussy approach, consultation with the level three committees (CESR in the case of UCITS) is an essential step in the preparation of detailed technical measures to complement the general principles adopted at level 1. Against this background, the Commission services sent a formal request for advice to CESR on 13 February 2009 asking for its technical assistance across the different areas in which implementing measures were envisaged. This request was structured into 3 parts, structured according to whether the adoption of level 2 implementing measures was mandatory or optional, and reflecting the priority accorded by the level 1 Directive to the different implementing measure.[8] The first part related to detailed measures for the management company passport; the second related to the development of measures for harmonised and standardised pre-contractual information for investors; the third related to certain supporting measures in regards provisions on mergers, master-feeder structures and notifications between supervisors relating to cross-border sales of UCITS.

Due to time constraints, the deadline for advice was set for 30 October 2009 for the first and the second part of the mandate. Some flexibility was however granted to CESR in several non-priority areas, in particular for the third part of the mandate, where the Commission grouped together issues where there was discretion on whether further legislation at level 2 was appropriate. Here, CESR's advice was requested by December 2009.[9] The Commission closely followed all of the working groups set up by

[7] See Annex II, section 10.

[8] For the content of the three areas, please refer to section 3 in Annex I.

[9] To see all three final advices of CESR please refer to:

CESR for addressing the individual issues raised for the implementing legislation. CESR issued public consultation papers on its proposed advice on the first two parts of the mandate on 7 July 2009. (In the area of pre-contractual information for investors, this followed earlier consultation and advice to the Commission on the general approach back in February 2008.[10]) The consultations ended on 10 September 2009, following a public hearing on 1 September 2009. Consultation papers on part III of the mandate were issued in September 2009 with a consultation period running through to November 2009. These consultations respected Commission standards for consultation in terms of openness, transparency and the minimum consultation period.[11]

(1) How CESR's advice has been used

CESR's advice to the Commission has been vital for ensuring an effective and transparent assessment of the appropriate content of the level 2 implementing legislation and consulting on that content with wider stakeholders. CESR's public consultation on its advice contained targeted questions to stakeholders on the possible impact of proposed measures, possible alternative solutions, and expected costs and benefits of the measures. Given the number, variety and technicality of issues to be considered for the level 2 implementing legislation, this was a proportionate way to ensure options and their impacts could be objectively analysed.

It remains the Commission's prerogative to determine the content of level 2 implementing measures, taking account of the inputs and evidence gathered, including but not limited to of the advice of CESR. In the majority of areas, CESR's advice reflected the emergence of a strong consensus amongst national supervisors, based on open public consultation of all stakeholders and detailed analysis within working groups of the potential impacts of proposed options. Given this, it is appropriate for this impact assessment and the accompanying level 2 implementing measures to draw very strongly on the work done by CESR; in large part, the solutions identified and assessed in this impact analysis are those proposed by CESR. However there are some areas where the Commission has departed from the advice of CESR; these areas are clearly identified in the body of this impact assessment.

(2) Lessons learned

Part I: CESR's advice on the level 2 measures related to the UCITS management company passport
http://www.cesr-eu.org/index.php?page=document_details&id=6150&from_id=28
Part II: Final advice on the level 2 measures related to the format and content of Key Information Document disclosures for UCITS
http://www.cesr-eu.org/index.php?page=document_details&id=6149&from_id=28
Part III: CESR's technical advice to the European Commission on level 2 measures relating to mergers of UCITS, master-feeder UCITS structures and cross-border notification of UCITS
http://www.cesr-eu.org/index.php?page=document_details&id=6359&from_id=28.

[10] Available at: http://www.cesr.eu/index.php?docid=4955.

[11] **17/2/2009** CESR call for evidence on possible implementing measures of future UCITS Directive (http://www.cesr.eu/index.php?page=consultation_details&id=132)
16/3/2009 CESR Consultation on technical issues relating to Key Information Document disclosures for UCITS (http://www.cesr.eu/index.php?page=consultation_details&id=134)
15/06/2009 CESR Consultation on CESR's technical advice at level 2 on Risk Measurement for the purposes of the calculation of UCITS' global exposure (http://www.cesr.eu/index.php?page=consultation_details&id=140)
04/08/2009 Consultation on the addendum to CESR's consultation paper on the format and content of Key Information Document disclosures for UCITS (http://www.cesr.eu/index.php?page=consultation_details&id=147)
08/07/2009 Consultation on CESR's technical advice to the European Commission on the level 2 measures related to the UCITS management company passport (http://www.cesr.eu/index.php?page=consultation_details&id=144)
8/07/2009 Consultation on CESR's technical advice at level 2 on the format and content of Key Information Document disclosures for UCITS (http://www.cesr.eu/index.php?page=consultation_details&id=143)
17/09/2009 CESR's technical advice to the European Commission on level 2 measures relating to mergers of UCITS, master-feeder UCITS structures and cross-border notification of UCITS (http://www.cesr.eu/index.php?page=consultation_details&id=148)

Given the wide range of issues being addressed and their technical complexity, the advice of CESR has been instrumental in assisting the Commission in preparing implementing measures. However, since the advice of CESR plays such an important role, it is vital that an effective assessment of impacts is integrated within CESR's own work, and that there is good practical coordination between this impact assessment work and that of the Commission. In practice, given very strong pressures on time and the scale of the task, CESR was not always able to fully present their assessment of issues through a clear identification of alternative options and analysis of the impacts of these in relation to stated objectives.

The Commission may aid CESR and promote greater coordination in relation to impact assessment work by ensuring future mandates for CESR's advice clearly establish the objectives sought in relation to each issue on which advice is sought, and constraints (or lack of them) that exist in relation to options that ought to be considered. In addition, strong bilateral communication between CESR and the Commission is vital for facilitating coordination in analysis. Logistics can become complicated, since Commission resources are in some cases necessary to ensure delivery of appropriate evidence at the appropriate time to inform the CESR work on assessing different options, as in CESR's work on key investor information (KII) disclosures, which was supported by consumer testing contracted by the Commission. Strong commitments by both CESR and the Commission proved essential in ensuring the effective delivery of the CESR advice on KII. In particular, the Commission should, where seeking the advice of CESR, seek to be explicit from the very beginning as to the necessary targeting of impact assessment work, and should, in collaboration with CESR, examine in great detail the appropriate division of work.

2.2.2. *External expertise*

(1) Two external studies for retail fund disclosures – Key Investor Information

In order to complement internal research and CESR's work on level 2 implementing measures, the Commission launched two studies:

- Investor testing of possible new format and content for retail fund disclosures – Key Investor Information (KII);
- Cost and Benefits of the Key Investor Information – testing of the new pre-contractual disclosure document (KII) with UCITS fund managers.[12]

A noted factor in the existing failure of regulation in regards investor disclosure was the lack of investor testing of previous disclosure requirements. For this reason the first study has been instrumental in the development of detailed evidence-based proposals for the form and content of investor disclosures. The study focused on investor preferences in regards the disclosure of information about funds, but importantly also examined investors' practical use of information and comprehension of messages. The study directly informed the work of CESR in developing detailed proposals in an iterative fashion, as different options proposed by CESR were tested with retail investors to examine which were better understood and used by those investors.

The second study provided data in particular on the costs for the industry of introducing a new disclosure document. This data, when combined with the findings from the first study, has allowed for a quantification of the costs and benefits of different options, including an assessment of the major impacts of proposals for the industry. [13] (Importantly, however, these costs are largely determined by the decision taken at level 1 to strongly standardise and harmonise the disclosure document).

(2) Other external studies

[12] Available at: http://ec.europa.eu/internal_market/investment/docs/other_docs/research_report_en.pdf.

[13] See section 3, Annex I for further details on these studies.

This impact assessment has also made use of other studies that were launched earlier but were not necessarily designed to inform the Commission's work in the UCITS area. They were of a broader scope and focus, including non-harmonised investment funds. They include in particular the following:

- Investment funds in the European Union: comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets;[14]

- Current Trends in the European Asset Management Industry;[15] and

- Study on the costs of compliance with selected FSAP measures.[16,17]

3. Problem Definition

3.1. Background and context

The new level 1 Directive tackles problems in the following four areas:[18]

(1) *Problems in using the management company passport effectively – lack of flexibility in organising the industry value-chain.*[19] A management company passport (MCP) allows a UCITS to appoint a management company in another Member State, or a management company to establish a UCITS in another Member State. Provisions for a MCP were introduced in 2001, yet have not functioned in practice. As a result, fund managers had in effect to establish management companies in the domiciles of each of their funds.

(2) *Ineffective disclosures to investors*. The Simplified Prospectus was intended to ensure retail investors could easily identify and understand key information about the fund pre-contractually. However, the document has in practice often been too long and complex and failed to enable effective comparisons between UCITS funds, ultimately leading to an increased potential for mis-sales.

(3) *Proliferation of funds of a sub-optimal size*. The European fund market is characterised by a high number of funds of small size: 65% of all funds manage less than €50 million in assets, and the average size of a UCITS is a fifth of that of an American counterpart. Economies of scale have thereby not been exploited, increasing costs for investors. The efficiency of (cross-border) business is furthermore hampered by the difficulty or even impossibility of merging funds (cross-border), or pooling the assets of funds.

(4) *Barriers to marketing of UCITS funds in other Member States' markets*. Notification procedures (where the management company directly notifies each host Member State authority) have often been cumbersome, time-consuming and expensive, at odds with the intention for a simple notification process, and, crucially raising costs. Significant differences across Member States in requirements have hindered competition and led to regulatory arbitrage.

The financial crisis has led to the addition of a fifth problem area (financial stability):

[14] Available at: http://ec.europa.eu/internal_market/investment/studies_en.htm.

[15] Ibid.

[16] Available at: http://ec.europa.eu/internal_market/finances/docs/actionplan/index/090707_cost_of_compliance_en.pdf.

[17] See section 3, Annex I for further details on these studies.

[18] More detailed information regarding these four problem areas can be found in the IA of the legislative proposal amending the UCITS Directive, pg 15-18 and also in Annex 7. The IA is available at: http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm.

[19] Although the IA of the legislative proposal amending the UCITS Directive concluded not to proceed with fixing this particular problem, the issue of making MCP workable in practice became salient during negotiations with European Parliament and the Council. For more information, please refer to section 1, Annex II.

(5) *Exacerbated financial instability and investor detriment during extreme financial crisis.*[20] Failings in firms' risk management and conduct of business across the whole financial sector have raised levels of systemic risk and led to investor detriment during the financial crisis. In light of this, effectiveness and efficiency of the UCITS framework needs to be assessed in relation to systemic risk and investor protection, notably in regards risk management and conduct of business requirements and remuneration policies.[21]

These five problem areas are not discrete, as can be seen in the problem tree (see section 3.4). Notably, all (with the possible exception of the last) erect barriers to an integrated EU fund market and reduce its efficiency, leading to more costly and less competitive fund offerings, while also reducing transparency across the market.

The first four of these problem areas have already been addressed through a two stage process. A first impact assessment was carried out in 2006, in preparation for the White Paper on enhancing the single market framework for investment funds. That assessment identified these broad problem areas and analysed high level options for addressing them. In 2008, a second impact assessment identified and assessed concrete options for changes to the UCITS framework. This impact assessment supported the Commission legislative proposal for the UCITS IV Directive, which introduced changes at level 1.[22]

The legislative solutions chosen at level 1 envisaged a further amplification or clarification of the application and content of the new framework in certain areas by means of level 2 measures.

Specific and circumscribed implementing powers were thereby bestowed on the Commission to develop these implementing measures; the Directive identified all areas where it would or might be necessary to introduce such measures. In some cases their development was seen as essential for the functioning of the solution adopted at level 1, and indeed a deadline was placed on the Commission to adopt the relevant measures; in other cases the adoption of implementing measures was seen to depend on an assessment of their necessity and impact. The specific issues in question in both areas are outlined in more detail section 3.3 below.

The current impact assessment relates specifically to these level 2 measures, rather than the UCITS package as a whole, but must nonetheless be considered in the context of the preceding impact assessments and the policy options selected at level 1. Indeed, many of the key impact drivers relating to the UCITS package relate to level 1 requirements rather than level 2 measures – the incremental impact of choices relating to level 2 measures is in general of lower material importance than that at level 1.

3.2. Issues to be addressed through level 2 measures

There are **20 specific level 2 areas**, as outlined in table 1 and 2 below.

[20] The financial crisis has had limited direct impact on UCITS in terms of closures or suspended redemptions, as the number of funds affected by these problems was very small, representing less than 0.04% of the total number of UCITS. The European Fund and Asset Management Association (EFAMA) estimates that assets of investment funds domiciled in Europe declined by 22.3% in 2008. This decline was driven by the developments in the UCITS market – representing 75% of the investment fund market in Europe. Market losses were responsible for 77% of the decline, whereas outflows added the remaining 23%. Around 37,000 funds. Source: EFAMA 2008.

[21] To ensure consistent and effective remuneration policies across the financial services the Commission will conduct a separate impact analysis concerning regulatory requirements for remuneration in the UCITS market. This impact assessment will therefore not consider this issue any further. The crisis has led to changes in the wider regulatory context that require consideration – notably, the Commission Communication on Remuneration issues, associated Recommendations, and consequent legislative steps to amend the Capital Requirements Directive. http://ec.europa.eu/internal_market/company/directors-remun/index_en.htm.

[22] See Annex I section 1 (Table 3) for an outline of these changes.

This impact assessment will not analyse each of them in depth. This is mostly because they concern matters where the impact for all stakeholders of the choice between different options can be seen to be negligible (e.g. the choice of one harmonised format of information over another). In addition, these are often areas where the key impacts for stakeholders are determined by policy solutions selected already at level 1, such that the incremental impact of choices at level 2 is of low materiality. In addition, there are also certain areas which will be addressed in the future by other initiatives, and a full impact analysis will be conducted of options for these areas in the context of these other initiatives.

For each of the areas which is not being assessed in detail an explanation of the criteria used for this decision is provided in Annex I section 4.

The issues which form the substance of this impact assessment are those for which significant costs and benefits are likely for stakeholders. Section 3.3 will outline each of these issues, its relationship with the problem areas above, and its relation with the level 1 framework.

Table 1: Overview of issues addressed in detail in this impact assessment

Problem area	Number	Content
A: MCP	**1**	Inconsistencies in and inappropriateness of organisation, conduct of business, conflicts of interest rules for management companies
A: MCP	**2**	Inconsistencies in and inappropriateness of risk management
B: Pre-contractual disclosure	**3**	Investors unable to make informed investment decisions: disclosures do not engage the interest of investors, are difficult to understand and hard to compare)
C: Mergers and Master-Feeder	**4**	Inadequately informed investors on the impact of the merger of a fund in which they invest (4.a) or the conversion of a fund into a feeder or change of the feeder's master UCITS (4.b)
D: Notification	**5**	Ineffective and inconsistent mechanisms for communication between competent authorities in relation to the notification procedure

Table 2: Overview of areas for which implementing measures are being considered but are not addressed in detail in this impact assessment

Problem area	Number	Content
A: MCP	**6**	Content and format of an agreement between depositary and a management company of UCITS in a cross-border situation
A: MCP	**7**	Regulatory requirements relating to direct sales to investors by UCITS management companies
A: MCP	**8**	Supervisory cooperation (content of the procedure to be followed when competent authorities intend to carry out on-the spot verification or exchange of information)
B: Pre-contractual disclosure	**9**	Restrictions to apply in relation to the use of durable media for provision of KII or prospectus to investors
C: Mergers	**10**	Content and the format of the information related to merger of UCITS that should be provided to investors
C: Master-Feeder	**11**	Content and format of the agreement rules between feeder and master UCITS and the clarification of the applicable law of the agreement between feeder and master
C: Master-	**12**	Content of measures to avoid market timing

Feeder		
C: Master-Feeder	13	The procedural steps for seeking supervisory approval in cases of liquidation, merger or division of the master UCITS
C: Master-Feeder	14	The content and format of the agreement between depositaries and auditors
C: Master-Feeder	15	The definition of irregularities which the depositary of a master UCITS has to report (including how this reporting shall proceed)
C: Master-Feeder	16	The format of the information on a conversion into a feeder UCITS or on a change of the master UCITS that should be provided to investors
C: Master-Feeder	17	Contributions in kind – particulars of the contribution in kind that need to be stipulated in the agreement between the feeder and the master UCITS
D: Notification	18	Publication of information on laws of UCITS host Member State specifically related to arrangements made for marketing of UCITS in that Member State
D: Notification	19	Content and format of standard notification letter and standard model attestation of UCITS
D: Notification	20	Facilitation of access for the competent authorities of the UCITS host Member State to the statutory information of UCITS (i.e. fund rules, key investor information, arrangements made for marketing).

3.3. Specific issues to be addressed through level 2 implementing measures

This section provides an overview of the specific issues addressed in this impact analysis. Further detail can be found in the relevant annex listed under each sub-heading.

3.3.1. ISSUE1: Inconsistencies in and inappropriateness of organisational requirements, rules on conflicts of interest and rules of conduct for management companies (Annex II, section7)

Inconsistent approaches have emerged between Member States as to the general rules that apply to the basic functions of the management company. The UCITS framework (prior to the UCITS IV changes) did not strongly harmonise these requirements, permitting Member States to adopt variant national regimes.

This raises two types of issue. Firstly, inconsistencies between Member States can generate specific issues relating to the functioning of the single market in UCITS. This is primarily through the impact of an unlevel regulatory playing field on cross-border business. Linked to this, issues can also arise in relation to different treatments of similar business activities (for instance, as between pure UCITS asset managers and asset managers conducting similar business outside UCITS), which can create market distortions through regulatory arbitrage. Secondly, organisational, conduct of business and conflicts of interest requirements are designed to ensure sound management principles for all UCITS; where these may not be sufficiently robust in some Member States, this might lead to investor protection concerns.

In addition, when transposing the Markets in Financial Instruments Directive 2004/39/EC[23] and its implementing legislation[24] (further referred to as MiFID) some Member States have chosen to apply standards derived from the MiFID framework to UCITS management companies, so as to address level-

[23] OJ L 145, 30.4.2004, p. 1–44 , http://eur-lex.europa.eu/.

[24] Commission Regulation EC/1287/2006 OJ L 241, 2.9.2006, p. 1–25 and Commission Directive 2006/73/EC OJ L 241, 2.9.2006, p. 26–58 .

playing field and investor protection concerns at the national level (MiFID outlines detailed conduct of business requirements and harmonised these to a much greater extent than the UCITS Directive); others have not done so.

The introduction of MiFID has also more directly impacted UCITS business, since across all Member States certain MiFID rules apply to management companies that offer an investment service of individual portfolio management.[25]

The most prominent inconsistencies between the minimal and non-harmonised UCITS regime prior to UCITS IV and the standards certain Member States have applied to UCITS so as to create consistency with MiFID include:[26]

- UCITS management companies are subject only to high-level conduct of business principles relating to *best execution,* whereas MiFID provides for detailed rules on how instructions are to be executed.

- UCITS requirements on *conflicts of interest* are lighter than those in MiFID. Firms subject to MiFID rules have to deal not only with actual but also with potential conflicts of interest.

- Firms subject to MiFID must organise compliance, risk management or internal audit functions in an *independent* manner. For UCITS, there are no detailed provisions of this kind.

Taken together, the impact of inconsistencies in national approaches was considered by Member States to undermine mutual confidence between supervisors and thereby to act as a barrier to the effective functioning of the MCP. On the basis of these concerns the UCITS IV Directive thereby requires *further harmonisation in these rules through the adoption of implementing measures*. The level 2 issue to be assessed in this impact assessment relates therefore to the precise *content of that harmonisation*. Given that many Member States have already moved towards an approach derived from MiFID, the key question is whether all Member States should be required to harmonise around such an approach.

In principle inconsistencies concern all UCITS management companies (around 1400), the 35.000 UCITS funds they manage with assets under management of around EUR 5.2 trillion and the investors who buy them (very broad estimate indicates around 70 million unit holders).[27] In practice however, the extent and distribution of the inconsistencies is crucial in assessing the scale of this issue. A good indicator of this, given the preponderance of requirements across different Member States derived from MiFID, is the number of management companies that currently do not – either voluntarily or due to differences in national regimes – comply with a MiFID-style conduct of business regime. On the basis of preliminary work conducted by the CESR in 2007, the number of management companies that are domiciled in those Member States that do not align their regulatory requirements with those of MiFID, is approximately 470 entities, which corresponds to approximately 30% of all management companies, managing about 40% of UCITS assets in 38% of funds.[28] However these estimates may overstate the number of management companies impacted, since (1) robust data on group arrangements is not available and (2) it is not possible to account for those management companies that do both MiFID as well as UCITS individual and collective portfolio management and decided to apply MiFID rules on a voluntary basis. It is also evident from replies of several industry associations to the CESR's consultation that a number of their members have voluntarily chosen to align internal compliance functions around MiFID standards.

[25] In these cases the UCITS Directive already states that Articles 2(2), 12, 13 and 19 of MiFID shall apply.

[26] For a full overview of MiFID and UCITS interactions pleas refer to ECMI Policy Brief paper, April 2008.

[27] See Annex II, section 9, Table 9.2.

[28] Source: ZEW-OEE database, www.oee.fr, data from EFAMA FERI FMI, ZEW calculation of 2005.

3.3.2. ISSUE 2: Inconsistencies in and inappropriateness of risk management (Annex II, section 7)

Issues with risk management of UCITS can be seen in two areas.

Firstly, the **governance and organisation** of UCITS' risk management processes are of key importance in ensuring their effectiveness. Governance and organisation covers such aspects as the definition of roles and responsibilities, including for the board of directors and relating to internal reporting; operational requirements relating to the risk management function and its organisation; and the sound operation of safeguards where risk management activities are performed by third parties.

As under issue 1, there are significant inconsistencies in the approaches taken by different Member States. Box 1 outlines key inconsistencies that were identified within a CESR mapping exercise of Member States' regulatory approaches to this issue.

Box 1: Member States' regulatory practices with respect to **governance and organisation** of the risk management process of UCITS management companies

- There is no harmonisation in the regulatory practices on risk management measures. Only about half of the Member States' authorities perform ex-ante supervision of risk management policy and procedures of the management company at the time of its authorisation (although most of them do it on an on-going basis).
- The vast majority of Member States require that units in charge of risk management and asset management must be functionally segregated and operate independently but there are few Member States with no specific requirements.
- Most Member States allow for risk management to be delegated to a third party (although subject to conditions that vary between Member States) though there are few Member States that do not allow delegation.

In practice organisational and conduct of business arrangements relating to risk management are a subset of the wider arrangements discussed above under issue 1, where the migration of national regimes towards a MiFID-derived framework has been underway. The UCITS IV Directive has likewise required (so as to ensure the effectiveness of the MCP) that implementing measures harmonise supervisory practices across Member States in this area as a subset of the wider harmonisation required under issue 1; for this reason, issues with risk management organisational and conduct of business requirements will not be addressed separately in this impact assessment, but addressed through issue 1.

Secondly, and more substantively, the risk management process must be able to effectively **identify, measure and manage** the relevant risks; this is a crucial element of the UCITS risk management regime. It is key to ensuring that core elements of the UCITS risk framework, such as exposure limits, are effectively maintained and respected by the management companies.

Just as with the first issue, inconsistent approaches have emerged between Member States as regards the content of detailed requirements on risk identification, measurement and management.[29] This has

[29] Note that the risk management processes for UCITS must already have a sufficiently wide scope so as to encompass all relevant risks, so that the identification element of risk management is not artificially delimited: the Commission Recommendation 2004/383/EC on the use of derivatives by UCITS (OJ L 199, 7.6.2004, p. 24–29, http://eur-lex.europa.eu/) already established that all risks relevant to UCITS should be within the scope of its risk management policy. This approach was further confirmed in the Guidelines on Risk Management Policy for UCITS issued by CESR in February 2009 and subsequently in CESR's final advice submitted to the Commission in September 2009.

become a more important issue following UCITS III changes, which extended the range of eligible investments and investment strategies available to UCITS. Following these changes, UCITS risk management became increasingly complex for those UCITS that made use of the new investment possibilities, requiring increasingly sophisticated risk management processes.

Refinements to the UCITS framework and to Member States requirements on risk management, notably Commission Recommendation 2004/383/EC,[30] have attempted to address these developments by encouraging a general raising of standards and requirements across the UCITS industry. However, work undertaken by CESR during 2007 (see box 2 and 3) indicated a lack of consistency in Member States' regulatory practices on risk management measures and indeed a high level of divergence regarding implementation of related provisions of the UCITS Directive and the Commission Recommendation 2004/383/EC. Similar findings were revealed also by an external study conducted in selected Member States in the course of 2007-2008.[31]

To be more concrete, the key areas of divergence that have been identified relate in large part to technical matters relating to risk identification and measurement methodologies.

- Global exposure

The article 51(3) of the UCITS Directive places a cap on 'global exposure' (i.e. the extent to which the UCITS is impacted by movements in underlying asset values). While the assessment of such global exposure is relatively simple for straight equity funds, it can be more complicated for other funds. While Commission Recommendation 2004/383/EC outlined two broad methodologies (a so-called 'commitment approach' and an alternative methodology based on the calculation of Value-at-Risk (VaR) figures), the recent study[32] and survey noted above indicate significant variations at the national level (see box 2), including as to the degree of prescription.

Box 2: Member States' regulatory practices with respect to understanding of **global exposure** limits and requirements on their management and measurement

There is a high level of divergence regarding the implementation of the limit stipulated in the UCITS Directive (article 51(3)). For instance, over one third of Member States require exposures arising from derivatives to be included; others do not. Less than half of the Member States adapt risk measurement methodologies to the risk-profile of a UCITS – the 'Commitment' approach, Value at Risk (VAR) or other sophisticated methodologies are allowed to varying degrees, and Member States differ widely as to the parameters they require to be used within these methodologies. A half of the Member States require stress testing to help manage risks related to abnormal market movements, while only some Member States require back-testing of the risk measurement model against historic circumstances.

- Counterparty risk exposure

Article 52(1) of the UCITS Directive places limits on exposure to counterparties by means of OTC instruments, so as to limit the counterparty risk faced by UCITS. However, the technical application of these limits and related possibilities for 'netting' of exposures, raises a number of questions of interpretation and, as with the measurement of global exposure, differences have emerged between the approaches adopted in Member States (see box 3).

[30] Refer to previous footnote for the link to the Commission's Recommendation.

[31] For more details as regards the external study, refer to Annex I, section 3.2.1.

[32] Study on "investment funds in the European Union: comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets", http://ec.europa.eu/internal_market/investment/other_docs/index_en.htm#studies, see in particular section 6.1.

Box 3: Member States' regulatory practices with respect to requirements **on counterparty risk management** and measurement

There is no uniformity with regard to the calculation of counterparty risk including rules relating to netting of derivative positions or the use of collateral. Half of the Member States do not allow for variations in the amount of counterparty risk depending on the nature of the counterparty, while others allow variations within the limits set by the level 1 provisions. Only few Member States allow (under certain conditions) for the netting of counterparty risk on financial derivative instruments with the same counterparty.

- Valuation of OTC derivatives

Differences have also emerged as to how OTC derivatives[33] should be valued (largely since such valuations typically require modelling that itself entails approximations and assumptions to be made). A recent study[34] has shown that one principle for such valuations set in the UCITS Directive – that valuations should be subject to reliable and verifiable evaluation on a daily basis – has been transposed and interpreted very differently in Member States under review – Luxembourg, Ireland, Germany, the United Kingdom and Spain.

These inconsistencies in approach raise investor protection, level playing field and single market issues.

Investor protection issues arise where standards are not robust enough, raising the potential that UCITS expose investors to risks other than those expected in keeping with the UCITS investment policy. They can also arise where investors' expectations are not met given inconsistencies in approach. For instance, different approaches to the calculation of global exposure imply that some UCITS carry potentially higher levels of risk for a given strategy than others, depending on jurisdiction. As a result, although harmonised at EU level, UCITS would not ensure the same level of protection across different fund domiciles.

Inconsistencies also may impact financial stability, in that certain techniques (such as the use of stress testing by UCITS) can contribute to greater overall transparency and thereby predictability in the capital markets, yet these techniques are not used in a uniform fashion across jurisdictions. This can be exacerbated by the impact of regulatory arbitrage.

More generally, level playing field issues (where differences in standards promote regulatory arbitrage or distort the UCITS market) can lead to single market issues clustered around the impact of differences in approach on supervisory cooperation and mutual confidence, which further undermines the effectiveness of the MCP. For this reason, when Member States agreed to make changes to enhance the effectiveness of the MCP, it was also agreed that a requirement to introduce implementing measures should be linked to this new freedom, so as to ensure that once a management company is approved in one Member State it is subject to a harmonised set of standards across the EU. This was seen as a key pre-condition for ensuring that regulators did not create further barriers, in effect if not goal, to the freedom of management companies to provide their services across the EU.

The UCITS IV Directive therefore requires further harmonisation in risk identification, measurement and management by means of level 2 measures. The level 2 issue to be addressed focuses on the content of this harmonisation. In this case the benchmark for harmonisation is not MiFID, but Commission

[33] The future legislative framework governing OTC derivatives being currently and separately considered by the Commission should have a positive impact on the various risks UCITS funds are exposed to with respect to the OTC derivative. The issues that are linked to OTC derivatives within the work on level 2 measures for UCITS would however not be subjected to significant changes in the light of the proposed potential measures and their objectives outlined in the latest Commission Communication on OTC derivatives. Also Annex I, section 6 for more details on Commission's work on the future legislative measures with respect to the OTC Derivatives.

[34] See footnote 32.

Recommendation 2004/383/EC: the issue to be addressed relates to the identification and analysis of the steps that might be necessary to ensure both consistency (to address MCP and level-playing field issues) and effectiveness (to address investor protection issues) of measures derived from that Recommendation.

The focus of the analysis to follow is on assessing the degree to which it is necessary or even possible to set all the specific parameters of risk management and measurement through level 2 implementing legislation, or whether a mixture of implementing measures and level 3 guidelines or other means is more appropriate (and if so, what the precise content of this mixture should be). Investor protection and wider financial stability goals need to be met in a context where there is continuous development in regards the sophistication of risk identification, measurement and management techniques, yet also where financial innovation (new strategies and instruments) may lead to risks that are not adequately captured by pre-existing methodologies, requiring linked development in the risk management processes.

As explained for issue 1, in principle these inconsistencies concern all UCITS management companies (around 1400), the 35.000 UCITS funds they manage with assets under management of around EUR 5.2 trillion and the investors who buy them (very broad estimate indicates around 70 million unit holders). These inconsistencies will concern management companies to varying degrees depending on requirements of the regulatory regime in their EU domicile and in particular depending on the extent to which these regimes diverge from the results expected to be achieved on the basis of the Commission Recommendation 2004/383/EC. As the above tables indicate, divergences vary by Member State and issue, such that it is difficult to establish an overall picture. However, it can be estimated – taking the Recommendation as a benchmark -- that firms domiciled in approximately half (a sizeable proportion) of Member States would be concerned by steps to harmonise around that benchmark, given the range of variation in approaches. According to this very rough estimate, approximately 400 management companies might be significantly impacted, depending on the specific standards chosen for harmonisation. However, robust data on group arrangements is not available, and it is not possible to account for those management companies that decided to comply with the requirements in line with the Commission Recommendation despite the fact that their domestic regulatory regime does not require them to do so. Indeed a recent study[35] indicates that, although significant differences between Member States exist, these have not been material enough in their cost impact so as to trigger regulatory arbitrage.

3.3.3. ISSUE 3: Investors unable to make informed investment decisions: disclosures do not engage the interest of investors, are difficult to understand and hard to compare (Annex II, section 8)

While the UCITS framework (prior to UCITS IV) contained a framework of requirements on investor disclosures about the fund, the detailed implementation of these requirements has varied materially between Member States. These requirements have been generally considered ineffective: the impact analysis for level 1 changes concluded that the existing framework had led to documents that were too complex, difficult to read and understand, un-engaging, and difficult to compare between different UCITS. Key information about risks, costs and performance were calculated and presented inconsistently or so as to be difficult to use, and detailed content or presentation of information was not standardised.

[35] See footnote 32.

Research shows that standardisation in content and presentation of information aids investors in comparing between funds and, if standardisation focuses on delivery of key information in an investor-friendly manner, it can aid comprehension of messages and engagement with disclosures.[36]

In the absence of effective disclosures, investors (particularly if buying without advice) may mis-buy or be mis-sold inappropriate funds, leading to an increased potential for unanticipated investor losses and complaints and a concomitant breakdown in investor confidence. Divergences in supervisory practices can also increase costs for firms operating across border (or erect barriers to such activity), whilst undermining cooperation and mutual confidence between supervisors.

3.3.4. ISSUE 4: Inadequately informed investors on the impact of the merger of a fund in which they invest (4.a) or the conversion of a fund into a feeder or change of the feeder's master UCITS (4.b) (Annex II, section 9)

UCITS IV introduced a new framework that allows for cross border fund mergers (4a).[37] It also introduced a new framework allowing master-feeder structures (4b) to be recognised as UCITS, in both domestic and cross border situations. As part of these new frameworks, the UCITS Directive requires fund managers to provide investors with information -- about the merger once the merger has been authorised by the relevant competent authorities but before the merger takes effect, and also about the conversion into a feeder UCITS or the change of the master UCITS. This is because all of these events constitute fundamental changes in the investment policy of the UCITS. This information is necessary if investors are to be able to make informed judgements on the possible impact of the events on their investment. The information is also necessary so they can exercise the rights provided to them by the UCITS IV level 1 provisions, notably the right to redeem free of charge before any change takes place.

Level 1 provisions do not contain any further detail on how the information about these events should be provided. The Commission has explicitly been empowered to specify these details through level 2 measures, should a case be made for such a measure. The level 2 issue here relates to the extent to which differences between Member States in the approach to communications with investors may mean some investors are not effectively informed – in particular, in some jurisdictions a passive form of communication is adopted (where changes to the UCITS are communicated by means of newspapers or official journals), while in others investors would be required to be actively contacted, whether through personalised electronic communications or through paper-based mail. The approach to providing information to investors is to some degree dependent on how the units in the UCITS are held. Mapping of Member States regimes indicate that while in the majority of cases a register of unit holders is maintained, in a minority of cases UCITS may issue units in a bearer form or the identity of unit holders may not be known or readily knowable to the UCITS or its management company.

Since both regimes (mergers and master-feeder) are new as established by UCITS IV amendments, there is no concrete evidence of a scale of investor detriment in this area. However, the impact analysis leading to the amendments of the UCITS Directive on Level 1 concluded that proliferation of funds of sub-optimal size was a real problem, and that the UCITS industry could achieve significant economies of scale if barriers to efficiency were overcome, that would then indirectly be passed on to investors in terms of lower fees. The legal framework on cross-border fund mergers and for master-feeder structures has been introduced to achieve these objectives. And it is expected to have a considerable impact on UCITS funds and their investors.

[36] The contractors for the KII consumer research came to these conclusions (see conclusions in chapter 10, pp. 150-154).

[37] Please note that a merger of two UCITS which are established in the same Member State is deemed to be a cross-border merger where at least one of those UCITS is also marketed in another Member State.

The impact analysis of the Level 1 changes to the UCITS Directive showed that in 2006 around 600 domestic mergers occurred compared to only 7 that occurred cross-border. The scale of the problem at level 2 can then be estimated as the extent to which national approaches might prevent investors from making informed decisions. If we consider that about 500 mergers would occur on a cross-border basis that would involve around 1000 UCITS funds per year (2.7% of the whole UCITS fund population) and approximately 2 million of investors[38] of which about 700.000 would be households or retail unit holders.[39] If we consider that about 55% of investors are based in Member States (eleven Member States) where they are provided with information directly/actively, impacted investors can be estimated to be in the region of 900 000 for mergers, and a similar estimate can be assumed for master-feeder structures; in total roughly 1.8 million of investors might be impacted. The eleven Member States where provision of active information is the prevailing norm represent about 850 of active managers (60% of all UCITS managers in the EU).[40]

These estimates need to be taken with caution, since it is expected that a gradual take-up of the new regime will occur in the first two to three years following their entry into force. However, a study conducted recently among selected UCITS managers shows that there is a real appetite for cross-border mergers.[41] The key drivers are diminishing returns, but also high operational costs. When asked of the likely destination to consolidate assets following cross-border mergers, a great majority of them preferred Luxembourg, Ireland but also their EU group headquarters, and the same results emerged with respect to master-feeder structures.

3.3.5. *ISSUE 5: Ineffective and inconsistent mechanisms for communication between competent authorities in relation to the notification procedure*

UCITS IV introduces a new notification procedure; this removes the possibility of an ex-ante check of marketing arrangements by authorities of the UCITS host Member State (marketing arrangements are not harmonised by the UCITS framework), and takes steps to improve time to market by facilitating immediate access of UCITS to host markets. The backbone of this new procedure is swift communication between home and host authorities, in particular with the use of electronic means to speed up processes and increase their reliability.

Luxembourg and Ireland remain the key centres where funds aimed at cross-border or international distributions are domiciled. However, we can observe that also other Member States have emerged as important centres for cross-border fund domiciliation, in particular the UK, France, Belgium and Germany, from which funds are being distributed mainly to other European countries. Supervisory authorities in these countries will act in the role of the home Member States for the purposes of cross-border notification of these funds. Key EU target markets for the notification of cross-border funds are Germany, France, Spain but also the UK and Sweden and authorities in these countries will then be in a position of the host authorities – at the receiving end of the notification file. The volume of such cross-border activity is growing. In 2002 there were about 25.000 cross-border notifications of 3.750 cross-border funds. In 2008 the number of cross-border notifications more than doubled involving 7.366

[38] Based on EFAMA statistics, some Member States (DK, DE, ES and SLO) report the number of unit-holders in all investment funds domiciled in their countries. Estimated number of UCITS unit-holders in these countries was calculated taking into account the proportion of UCITS funds to all investment funds in these countries. Based on these estimates, it was possible to calculate potential average number of unit-holders per UCITS fund in these countries. Taken together, the average number of UCITS investors per UCITS fund is approximately 2.000 investors. See Annex II, section 9 for more details.

[39] Proportion of investment funds held by households in the EU is 37%: EFAMA Fact Book 2009.

[40] The highest proportion of households investing into funds are observed in Sweden, France, Poland, Belgium, Finland, Germany, Italy, Austria, Spain and Hungary (range from 26% to 10% of households total financial assets). EFAMA Fact Book 2008.

[41] UCITS IV: Which business model for tomorrow? RBC Dexia Investor Services and KPMG, 2009 http://www.rbcdexia.com/documents/EN/Misc/UCITS%20IV%20report.pdf.

fund.[42] Cross-border mergers are however expected to take-off as a result of the latest amendments of the Directive, which may increase the volume of cross-border business.

Box 4: Four stages of the notification procedure:

1) A management company prepares a notification letter with supporting documents and sends it to its home authority.

2) The home authority receives the file, verifies whether the documentation is complete, attaches the UCITS attestation and prepares transmission of a notification packages to the host authorities.

3) The notification package is transmitted to the host authorities.

4) The host authority receives the complete package; the home authorities notify the UCITS that the file has been transmitted. UCITS has a right to access the market of the host Member State from the date of notification that the complete file has been transmitted.

There are two dimensions regarding the new procedure of notification introduced via level 1 amendments of the UCITS Directive where potential inefficiencies and problems could arise. The first one relates to the procedural arrangements between host and home authorities as regards transmission and reception of the notification file (stage 3 and 4 in the notification procedure). The second area of potential problems relates to the efficiency and effectiveness of electronic transmission and the means used for such transmission.

(i) procedural aspects

The new notification procedure removed the possibility of host authorities verifying the content of the notification file before a UCITS is permitted to start marketing its units in the host territory. However, there remain some practical questions as to how the supervisory authorities in a host Member State should prepare for on-going supervision of the marketing of units of the UCITS within the scope of their competences. Level 1 provisions do not determine all the details as to what constitutes a complete transmission, and what should happen if problems during the process arise and how quickly they should be resolved. Instead the co-legislators provided for the option to adopt implementing measures on practical aspects related to the use of electronic communication between competent authorities. The transmission of the complete file, followed by the notification of the UCITS of this transmission by home authorities, determines point in time where UCITS can access the market of a host Member State.

Given the notification procedure has been completely overhauled, there can be no concrete existing evidence of failures or problems arising from different approaches among the host and home authorities across Member States when dealing with incomplete or failed transmissions of notifications. However, given the high number of funds that are distributed cross-border and a high number of notifications on a yearly basis, different approaches among relevant authorities could negatively impact the simplicity and swiftness of the new procedure. To illustrate the scale of the issue, if problems arose in, say, about 20% of cases, that would each year impact around 10.000 notifications for around 1.500 funds .

To demonstrate this, we can consider the most common situations, where Luxembourg and Irish authorities in their role as predominantly 'home' authorities transmit notification files to a number of host Member States' authorities. Should the procedures for electronic communication be different in each of these host Member State as regards the way the notification file is transmitted, including different channels, systems, formats of files or the timing and conditions under which both parties should take any corrective action then the home authorities would not only need to adjust to the situation in each and every Member State but it would lead to potential disputes among the authorities. Competent authorities

[42] See: Global Fund Distribution, June 2009, PricewaterhouseCoopers. These data do not distinguish between UCITS and non-UCITS funds. However, if it assumed that that most/all of these cross-border registrations are actually UCITS (which is most likely, since non-UCITS funds do not generally benefit from a EU-wide passport).

would need to develop and maintain a plethora of bi-lateral arrangements to agree on the methods of communication, or work through bodies such as CESR to seek to establish common arrangements. Such a situation could harm the main objective of the new procedure - to facilitate a swift access of UCITS funds to cross-border markets. The need to deal with different procedures would also raise costs of processing notification file by home and host authorities and increase legal uncertainty.

(ii) use of electronic means for the notification procedure

The obligation to use electronic means for notifications by home and host authorities was brought about by the reform of the UCITS legislative framework at level 1 in order to improve cost efficiency. The use of electronic means implies a number of possible options, ranging from an simple e-mail exchange to an EU-wide database system.

Currently the most used electronic way to transmit information is via e-mails. In the four steps of the notification procedure the most resource intensive tasks are at the level of home and host authorities (stage 2 and 4 in the notification procedure), where human resources are used for tasks that are repetitive. The greater the manual intervention necessary in processing notification files and uploading and updating the statutory documents the greater the potential uncertainties and inefficiencies. These inefficiencies are linked with the following:

(i) automation of the procedure – here the manual intervention of home authority is linked to the verification of the documents sent by a management company, preparation of the package to be transmitted to the host authorities, the enclosure of right attachments, the transmission of the files, and the notification of UCITS of the transmission. In case of the transmission fails home and host authorities need to get in contact to rectify potential problems. The main concerns are related to completion of the file – ensuring the correct attachments are included and that it is transmitted to the right address. Problems also might arise at the end of the procedure. Home authorities have to be certain that the transmission of the file has correctly proceeded (in regards their domain of responsiblitiy) before they notify the UCITS on the transmission of the file.

(ii) the level of centralisation needed at EU level – here the question is whether all supervisory authorities should be processing all individual notifications or whether a centralised system at EU level could be useful; however the Level 1 does not allow for centralised processing – there must be always contact between home and host.

(iii) the level of standardisation – The level 1 directive does not specify in detail how the notification file should be transmitted. Inconsistencies in approach may lead to different channels of communication being used (fax, email etc). This might require additional resources to be employed by home and host authorities. In addition, the use of different formats of documents that might lead to incompatibilities. This might lead to unnecessary delays or addition costs The level 1 directive does not outline detailed steps to be taken by authorities if transmissions fail or turn out to be incomplete, raising additional areas of uncertainty.

In its advice, CESR identified a potential for further work on sophisticated electronic means for transfer of notifications, however it was not in a position to conduct a full identification and cost benefit analysis of available options, as this required further consultation with IT specialists. Due to this, the use of e-mail for electronic transmission remained for now the only immediately viable option, pending this further work. For these reasons, the IT dimension of the procedure of transmission and receipt of the notification file will not be further discussed in this analysis.

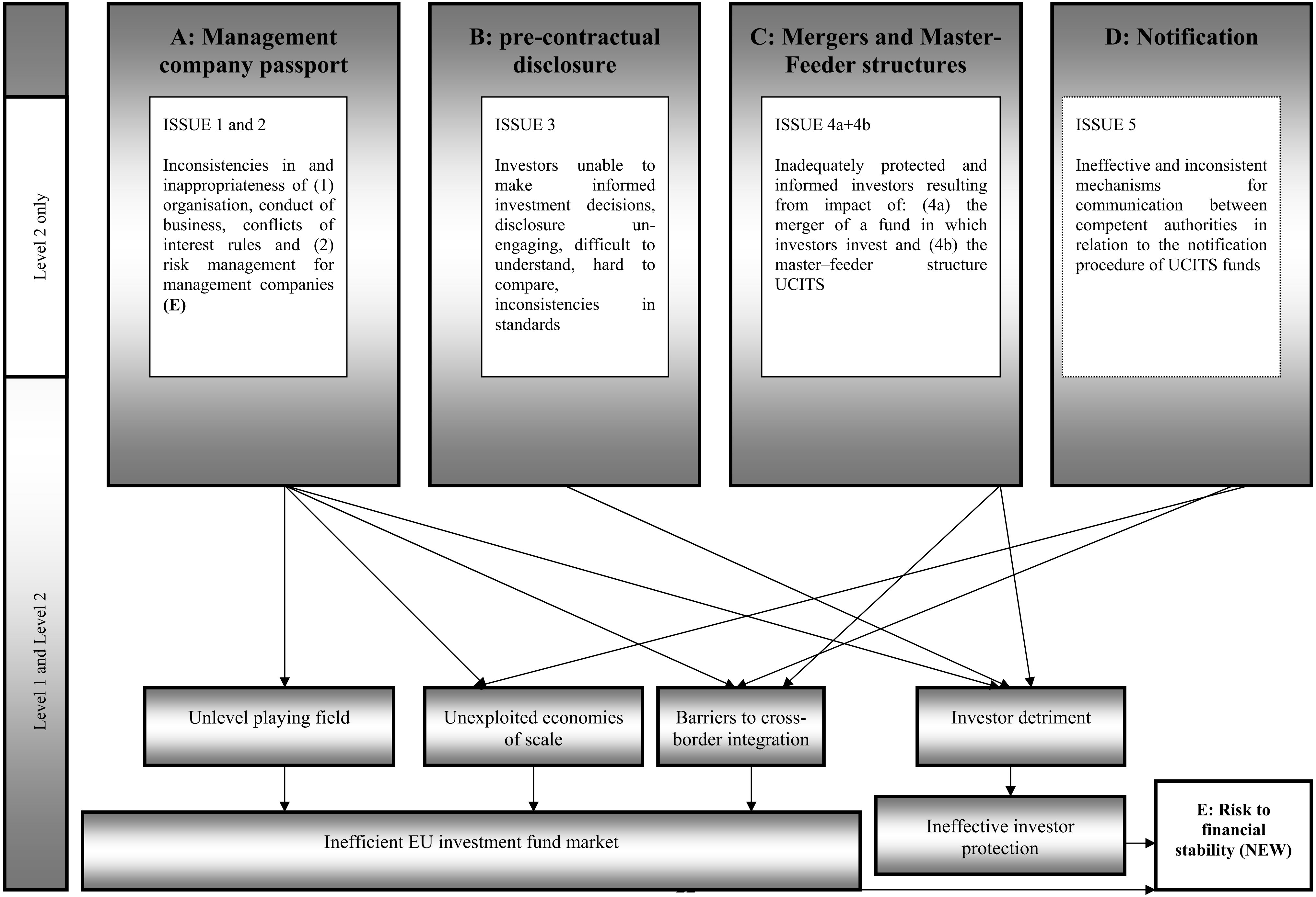
3.4. How would the problem evolve without action

In considering the evolution of identified issues in the absence of action at the European level, it is important to draw a distinction between those areas in which the Commission is required to act by decisions at level 1 (issues 1, 2 and 3 above) and those areas in where the Commission has discretion (issues 4 and 5).

In relation to the former issues, it is not possible to consider a base line of no action, as the positions taken at level 1 have already presupposed the adoption of level 2 measures at the European level: that is to say, there cannot in this case be a situation in which the problem evolves without further action at the European level, and level 1 and level 2 cannot be separated. The impact assessment for level 1 concluded that, in regards problem areas A and B, developments within the market and at the national level would not have led to improvements in the efficiency of the value chain for UCITS or in the quality and comparability of pre-contractual disclosures for investors, so that efficiency, competitiveness and consumer protection issues would remain significant without European action. The issue at level 2 is not whether action is justified, but the assessment of different technical options for such action in the light of their likely impact.

In relation to the latter issues, it can be expected that in the absence of action at the European level, requirements on the provision of information to investors in regards cross-border mergers and master-feeder structures would remain inconsistent across jurisdictions, leading to patchy investor protection standards. This is due to existing inconsistencies in terms of national approach at the domestic level (e.g. between passive and active standards on the provision of information) in cross-border situations.

In regards supervisory coordination over notification procedures, lack of action at the European level could lead to greater divergence in supervisory practices and continued fragmentation within the UCITS market, impeding single market benefits and leading potentially to greater costs for investors. These issues will be examined as part of the policy options analysis below.



Level 2 only

Level 1 and Level 2

A: Management company passport

ISSUE 1 and 2

Inconsistencies in and inappropriateness of (1) organisation, conduct of business, conflicts of interest rules and (2) risk management for management companies **(E)**

B: pre-contractual disclosure

ISSUE 3

Investors unable to make informed investment decisions, disclosure un-engaging, difficult to understand, hard to compare, inconsistencies in standards

C: Mergers and Master-Feeder structures

ISSUE 4a+4b

Inadequately protected and informed investors resulting from impact of: (4a) the merger of a fund in which investors invest and (4b) the master–feeder structure UCITS

D: Notification

ISSUE 5

Ineffective and inconsistent mechanisms for communication between competent authorities in relation to the notification procedure of UCITS funds

Unlevel playing field

Unexploited economies of scale

Barriers to cross-border integration

Investor detriment

Inefficient EU investment fund market

Ineffective investor protection

E: Risk to financial stability (NEW)

4. THE EU'S RIGHT TO ACT AND JUSTIFICATION

The UCITS framework exists at the European level as a mechanism for creating a single European market for retail investment funds. The problem areas addressed in the level 1 revisions for UCITS IV related to issues with the effective functioning of that framework that analysis showed required changes to that framework – by necessity action at the European level.

The specific issues identified in relation to UCITS IV implementing measures are strongly linked to and support these level 1 changes in the framework, and indeed are generally mandated as part of those changes at level 1. The analysis of concrete options for level 2 measures will consider the precise nature and extent to which harmonisation is necessary, always with the principle of subsidiarity in view. However, action solely at Member State level would not be able to effectively or efficiently address the issues that level 2 measures are being designed to address, given the centrality of the single market and cross-border dimension to the UCITS market. Action solely at Member State level would run the risk of erecting or maintaining barriers to further integration and efficiency in the UCITS market as a whole, including barriers to UCITS that operate on a cross-border basis, thereby potentially raising systemic risks and risks to investors in UCITS, whilst also increasing costs.

Consequently, the co-legislators, in requiring the Commission to develop implementing measures in relation to issues 1, 2 and 3, have taken the view that further harmonisation in regards the UCITS framework is necessary at the European level. In regards issues 4 and 5, the Commission is not required to adopt implementing measures, but the analysis in this impact assessment shows[43] that action purely at the Member State level would not effectively or efficiently address the issues.

The legal basis for action is provided (and delimited by) the implementing powers that have been created by the UCITS IV recast of the UCITS Directive.

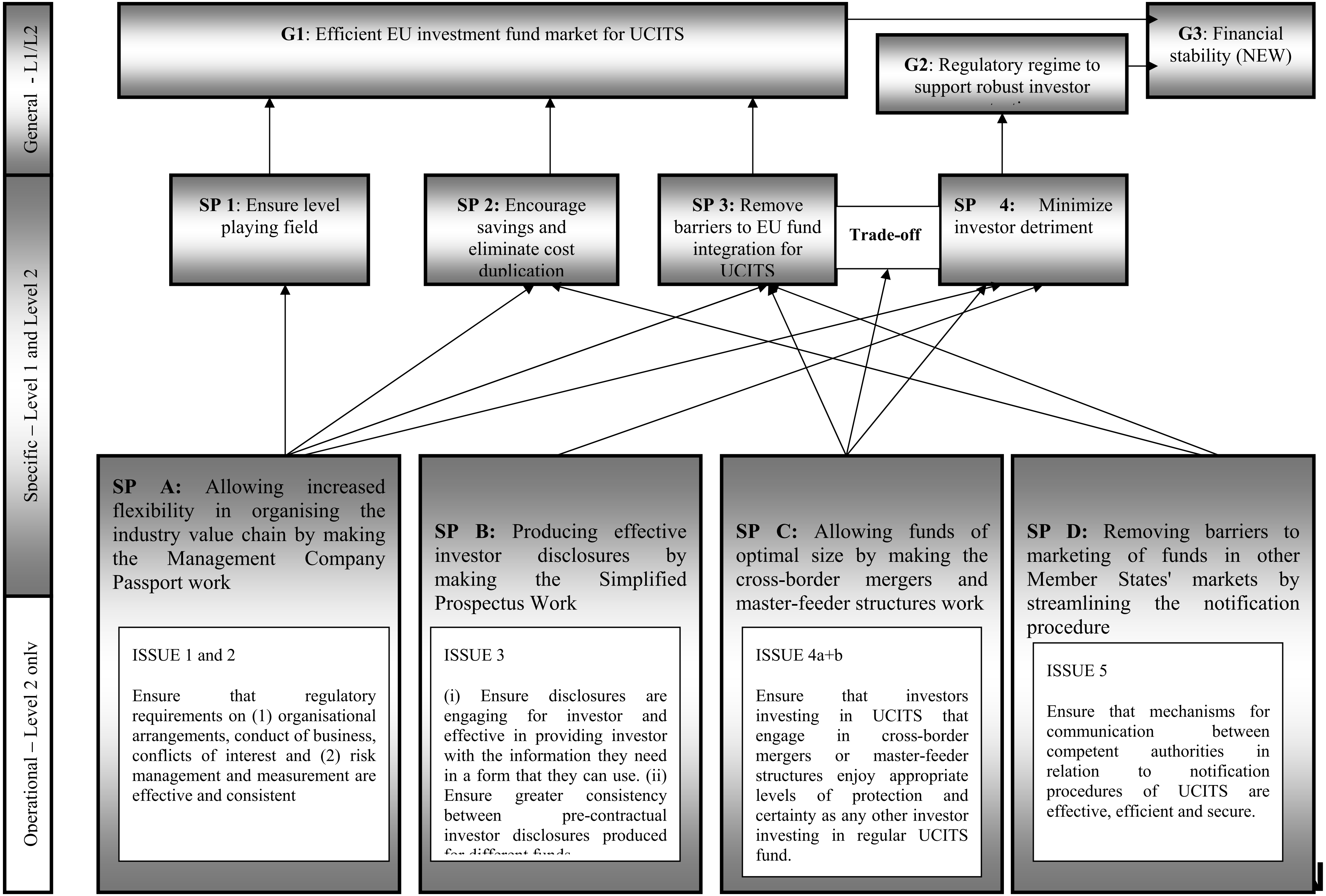
5. OBJECTIVES

The objectives identified at level 1 remain applicable for the relevant level 2 implementing measures, given that the underlying problems also remain the same. However, since the level 2 implementing measures are focused on specific issues, detailed objectives at level 2 can be more focused and delimited.

In addition, the financial crisis has added a fresh dimension to this work. The strategic, specific and operation objectives for level 1 already addressed transparency and stability goals in certain areas (for instance in regards investor protection, integration and level playing field objectives). Following the crisis, however, an explicit focus on an overall financial stability objective is warranted, so as to lay the basis for rebuilding confidence in the financial services through sound management and appropriate investor protection measures.

More detailed overview of the level 1 and related level 2 objectives is provided in Annex I, section 5.

[43] See section 6 of the impact assessment and Annex II, sections 7, 8 and 9.



General - L1/L2

Specific – Level 1 and Level 2

Operational – Level 2 only

G1: Efficient EU investment fund market for UCITS

G2: Regulatory regime to support robust investor

G3: Financial stability (NEW)

SP 1: Ensure level playing field

SP 2: Encourage savings and eliminate cost duplication

SP 3: Remove barriers to EU fund integration for UCITS

Trade-off

SP 4: Minimize investor detriment

SP A: Allowing increased flexibility in organising the industry value chain by making the Management Company Passport work

ISSUE 1 and 2

Ensure that regulatory requirements on (1) organisational arrangements, conduct of business, conflicts of interest and (2) risk management and measurement are effective and consistent

SP B: Producing effective investor disclosures by making the Simplified Prospectus Work

ISSUE 3

(i) Ensure disclosures are engaging for investor and effective in providing investor with the information they need in a form that they can use. (ii) Ensure greater consistency between pre-contractual investor disclosures produced for different funds

SP C: Allowing funds of optimal size by making the cross-border mergers and master-feeder structures work

ISSUE 4a+b

Ensure that investors investing in UCITS that engage in cross-border mergers or master-feeder structures enjoy appropriate levels of protection and certainty as any other investor investing in regular UCITS fund.

SP D: Removing barriers to marketing of funds in other Member States' markets by streamlining the notification procedure

ISSUE 5

Ensure that mechanisms for communication between competent authorities in relation to notification procedures of UCITS are effective, efficient and secure.

5.1. Consistency of objectives with initiatives in other areas

A relatively wide range of other legislative initiatives are currently underway, which either address similar objectives (financial stability, transparency, investor protection) for other financial services sectors (with or without potential for overlap), or address different objectives (improved supervisory architecture at the European level) but nonetheless have consequences for the objectives of this work.

The impacts of these initiatives have been considered where relevant.

6. ANALYSIS AND COMPARISON OF POLICY OPTIONS

This section provides a condensed view of the analysis and comparison of individual options. For each issue, the options are outlined, and a summary is provided of the analysis alongside a table capturing the assessment. For the additional background or more detailed analysis of some issues please refer to the relevant annex (as stated in the greyed-out box at the head of each section below). Following the analysis of individual issues, the choice of legal instruments is also addressed.

The baseline for the analysis of options depends on whether level 1 already binds the Commission to propose implementing measures for the issue in question, or whether level 1 provides flexibility on whether implementing measures are necessary. For the former the baseline is counterfactual (in which no action is taken) as this helps clarify the impact of the options, but is not a valid option in itself; for the latter, taking no further action is a valid option in itself, and needs therefore to be analysed on its own merits, but is also the baseline for assessing other options.

The objectives shown in the tables may be the general, specific or operational according to the issue, as, to aid clarity and ease of comprehension only the most relevant to the choice between options for each issue have been shown. The analysis has nonetheless been conducted on the basis of all the relevant objectives.

In the tables, the following signs have been used for assessing the magnitude of impact compared with the baseline scenario: “++” strongly positive, “+” positive, “—“ strongly negative, “-” negative, “=” marginal/neutral, “?” uncertain, and “n.a.” not applicable. These have been combined where relevant.

Following the summary of the options for each issue and the identification of the preferred option in each case, this section provides, under point 6.3, an overall analysis of the impact of the package of preferred level 2 measures, including the potential impact of the package for different stakeholders and risks to achieving the outcomes being sought.

ISSUE 1 Policy Options

Inconsistencies in and inappropriateness of organisation, conduct of business, conflicts of interest rules for management companies (Annex II, section 7)

Baseline No action [not a viable alternative given the legal obligation for the Commission to adopt harmonising level 2 measures by July 2010]

Option 1.2: Minimal level of harmonisation

Under this scenario, the minimal level of harmonisation consistent with level 1 requirements would be adopted. Significant variations between requirements at Member State level might remain, though a more detailed common framework would be applied.

Option 1.3: Great degree of harmonisation

Under this scenario, much greater degree of harmonisation in approach would be adopted; two sub-options emerge: whether for practical reasons the MiFID framework already adopted by a number of Member States would form the basis of this, or whether a wholly 'UCITS' model should be developed (potentially requiring those Member States that have already moved to MiFID approach to change their position).

From the perspective of UCITS management companies, options 1.2 and 1.3 would have different impacts in regards level playing field and MCP outcomes. Option 1.2 may not effectively reduce barriers to cross-border business, as differences in requirements would remain, and there is a risk that these inconsistencies could lead management companies to prefer to operate in each market separately rather than to offer services cross-border. The lack of a level playing field between firms (e.g. between those that are subject to both MiFID and non-MiFID regimes and those that keep to solely UCITS business) could also reduce effective levels of competition. Further, for supervisors, the residual inconsistencies under option 1.2 could well lead to reduced levels of mutual confidence and cooperation.

The costs expected to occur in both scenarios relate to one-off costs linked to the new requirements of the implementing legislation, and clearly scale in regards the extent of change at the national level. When compared to the baseline scenario, option 1.3 would most likely result in higher one-off and ongoing costs. However, ensuring option 1.2 is in practice consistent with the level 1 requirements – where greater harmonisation is being sought -- likely leads this option to be close to option 1.3. The general decision to harmonise measures more closely was made at level 1, and it can be seen that it is in principle this decision that drives change in relation to this issue, rather than the more focused issues as to what the content of the harmonised measures should be.

Respondents to CESR consultation did not provide concrete evidence in terms of quantifiable costs as to the option 1.3. The consultation however indicated a proportionately lower impact of harmonisation around MiFID basis than any other basis.

Overall, option 1.3 is most capable of delivering on the level 1 requirements and the outcomes being sought (level playing field, single market and, indirectly, investor protection), whilst minimising implementation/compliance costs where this gravitates to a MiFID framework that is already applicable to some UCITS and some activities undertaken by UCITS.

To elaborate, several Member States already have applied near complete read-across of MiFID provisions on organisational requirements for collective portfolio management of UCITS, for which the costs of option 1.3 would be none or minimal. There are few Member States with only a small extent of such read-across, with regulatory practices of many Member States lying in between these boundaries – in the latter category the adjustment costs would therefore be higher than in former group. According to our estimates the UCITS industry could face one-off costs ranging between EUR 150-300 million and ongoing costs ranging between EUR 80-250 million.[44] It is expected that only 10% of the asset managers impacted by the changes would be

[44] It needs to be pointed out that these figures are most likely to be lower when we consider the following factors: (1) it is not possible to account for those management companies that belong to the same group

of a small or medium-size. Again, for those most impacted by the changes, the driver of change is the level 1 requirement for more harmonisation, since those most impacted are in practice those working in jurisdictions that have taken a minimal approach to the implementation of conduct of business and other requirements on UCITS, and all steps consistent with the commitments undertaken at level 1 will create costs for these firms.

Aligning requirements on UCITS managers with those of MiFID regulated firms as envisaged in option 1.3 benefits investors both by increasing the competitiveness of the UCITS market (reducing cross-border barriers), but also by ensuring robust conduct of business and organisational requirements always apply to UCITS, reducing the potential for harm, e.g. through unmanaged conflicts of interest or the crystallisation of operational risks.

Option 1.3 is therefore the preferred option; this is in line with the final advice provided to the Commission by CESR.

ISSUE 1 Summary of analysis

Policy Option	Effectiveness			Efficiency
	Level playing field	Investor protection	Remove barriers to EU fund integration	
Baseline	0	0	0	0
Option 1.2: Minimal level of harmonisation	-	+	+	++
Option 1.3: Harmonisation on basis of MiFID	++	++	++	++

ISSUE 2 Policy Options

Inconsistencies in and inappropriateness of risk management (Annex II, section 7)

Baseline: No action [not a viable alternative given the legal obligation for the Commission to adopt harmonising level 2 measures by July 2010].

Under this scenario, there would be no level 2 measures and the status quo would prevail, i.e. high level principles of risk management at level 1, complemented by the Commission Recommendation 2004/383.

Option 2.2: **General/high level principles of risk management**

This option would be limited to further developing general/high level principles to be observed by management companies within the risk management process without any detailed harmonisation of the procedural steps to be observed when dealing with specific risks as identified by the risk management function. Member States may require more detailed steps.

Option 2.3: More detailed/prescriptive principles of risk management and measurement techniques at level 2

and operate in those Member State that provide for a little or no regulatory alignment with MiFID, (2) it is not possible to account for those management companies that do both MiFID as well as UCITS individual and collective portfolio management and (3) it is not possible to account for those management companies that decided to apply MiFID rules on a voluntary basis.

Under this option, specific principles of risk management and measurement techniques would be set out and harmonised at level 2, effectively moving certain elements (but not all) of the Recommendation to a binding level, but leaving more flexibility for member states over detailed technical approaches.

With respect to market risk, limits of **global exposure** as well as measurement techniques to be used for its calculation, (e.g. the use of Commitment approach, Value at Risk (VAR) approach as well as other more sophisticated methodologies) specific principles would be provided for at level 2. The detailed parameters of the underlying methodologies would be specified by CESR in the level 3 Guidelines (in the future potentially technical standards proposed by the new authority ESMA).

Similarly, with respect to **counterparty risk**, the principles of how to calculate exposure to counterparty risk in particular arising from the use of OTC derivatives would be set out at level 2. The details of how some of these principles or approaches should be implemented or used would then be further specified by CESR in the level 3 Guidelines (in the future potentially standards proposed by the new authority ESMA.

As regards procedures for **valuation of OTC derivatives**, addressing particularly valuation risk (operational), this option would entail that level 2 would set out specific principles of what needs to be done by the management company in order to ensure that assessment/valuation of OTC derivatives is accurate and independent. There would be no prescription of the specific models and valuation techniques to be used at level 2. These would however need to be subject to certain standards that are in line with the principles of risk management and measurement

Option 2.4: **More detailed/prescriptive principles of risk management and measurement techniques at level 2 complemented by harmonisation provisions for risk measurement techniques**

This option would build on option 2 but add details of the inherent parameters of underlying methodologies at level 2 rather than through guidance or technical standards. To the extent that ESMA did not adopt technical standards in this area under option 2.3, option 2.4 would represent a maximal degree of harmonisation of approaches across EU.

The fundamental issue facing risk management requirements relates to the extent of harmonisation that can be achieved with regards to the detailed requirements on risk identification, measurement and management. An overly prescriptive approach runs the significant risk of building regulatory failures into the management process, e.g. where a prescribed methodology is insufficiently effective or has its own distortions; yet an approach which is too high-level runs the risk of fragmenting and weakening the overall UCITS market, leading to regulatory gaps and arbitrage, and consequent investor protection issues.

The key issue therefore relates to the content of the risk management processes that a UCITS should follow. Such content does not need to be built from scratch: notably, it can be developed on the basis of the level 3 Guidelines on Risk Management principles for UCITS as adopted by CESR in February 2009[45] and the Commission Recommendation 2004/383/EC on risk measurement techniques.

Option 2.2 does not satisfy the relevant objectives. To set the principles at relatively high/general level would not ensure uniform application of the rules across the EU and such an uneven application could potentially result in different levels of investor protection. On the other end of the harmonisation scale, option 2.4 (when compared to option 2.3) would not have major cost impact from supervisors' perspective (though could require some supervisors to significantly change their approach) but may prove to be impractical and inflexible for the industry given that risk measurement techniques are an area in which continuous improvement as to the content of these techniques can be envisaged; fixing requirements at a particular point in time might impair the quality of approaches whilst also raising costs for investors (as the development of more efficient mechanisms is proscribed). This is particularly relevant given the likely emergence of new investment strategies over time, requiring, potentially, new

[45] CESR Guidelines on Risk Management Principles for UCITS, www.cesr.eu.

tailored risk identification and measurement techniques. Options 2.3 would retain some additional flexibility.

Option 2.3 will entail adjustment costs on the part of management companies as well as supervisors, but these can be expected to be tempered by the retention of flexibility. Respondents to CESR consultation did not provide concrete evidence in terms of quantifiable costs as to the option 2.3. However, more detailed prescription of risk management procedures appeared to be acceptable to the industry, as represented by option 2.3. Compliance costs will arise but will vary depending on what types of risk identification, management and measurement mechanisms UCITS managers have in place already and existing evidence suggests that alignment with principles embedded in the Commission Recommendation already has taken place in many Member States.[46]

The application of detailed technical requirements to all EU UCITS business – for instance, to apply back-testing, stress-testing or scenario analyses where appropriate -- might lead to system changes for the management companies, for instance requiring more specialist staff and support systems. However, greater harmonisation of the use of such technical approaches (where proportionate for the UCITS and its investment strategy) will raise overall risk management standards whilst improving consistency across the EU industry.

The adjustments expected to occur as a result of implementing option 2.3 can be considered to be similar to those expected in regards the preferred option for issue 1 (option 1.3) since both of the preferred solutions follow a more detailed principles based approach for the harmonisation via level 2 measures. The estimated cost impact as presented for the preferred option under issue 1 can in this regard be taken as a proxy since replies to the CESR consultation did not provide any estimates. However, the compliance costs cannot be expected to be in the same proportion as for the issue 1. The main reasons is the fact that unlike for issue 1, the Commission issued Recommendation in which it intended to harmonise number of the aspects that are now subject to implementing legislation and CESR mapping in this regard provides for enough evidence that although not full a considerable level of compliance on the part of management companies has already taken place. As such, it could be estimated that one-off costs and ongoing costs related to the adjustments in companies' risk management structures could be one fourth of those estimated for issues 1 i.e. one- off costs in the range of EUR 35-75 million and between EUR 20-60 million for on-going costs.[47]

Option 2.3 is therefore the preferred option and it is in line with the final advice provided to the Commission by CESR.

ISSUE 2 Summary of analysis

Policy Options	Effectiveness			Cost Efficiency
	Level playing field	Investor protection	Remove barriers to EU fund integration	
Baseline	0	0	0	0
Option 2.2: General/high level principles of risk management	-	-	-	--
Option 2.3: More detailed/prescriptive principles of risk management and measurement techniques at level 2	++	++	++	+
Option 2.4: More detailed/prescriptive principles of risk	+	+	-	-

[46] See Annex I, section 3.2.1 and Annex II, section 7.3.

[47] It should be noted that the same caveats apply also for option 2.3 as for the cost estimation of option 1.3 for issue 1.

management and measurement techniques at level 2 complemented by harmonisation provisions for risk measurement techniques				

ISSUE 3: Policy Options

Investors unable to make informed investment decisions: disclosures do not engage the interest of investors, are difficult to understand and hard to compare (Annex II, section 8)

Sub-Issue 3.1 – Overall approach

Baseline No action [not a viable alternative as Commission required to adopt level 2 measures]

Option 3.1.2: Highly standardised / harmonised document

Option 3.1.3: More flexibility over document

Under this sub-issue, the degree of flexibility or harmonisation/standardisation is considered. However, level 1 already prescribes a high degree of harmonisation, so in practice this sub-issue was largely determined and addressed by level 1.

Sub-Issue 3.2 – Risk Information

Baseline No action [not a viable alternative as Commission required to adopt level 2 measures]

Option 3.2.2: Synthetic indicator

Option 3.2.3: Narrative text

Under this sub-issue, different options for the presentation of information about risk are considered. Risk information is crucial for investors, as UCITS generally expose them to uncertainty as to outcomes, and retail investors are typically risk-averse and find such information difficult to understand. The investor testing exercise explored and refined different options (the use of an indicator or the use of pure narrative information) for addressing these challenges.

Sub-Issue 3.3 – Performance Scenarios

Baseline No action [not a viable alternative as Commission required to adopt level 2 measures]

Option 3.3.2: Backtesting

Option 3.3.3: Performance scenarios

Option 3.3.4: Performance scenarios with probability information

Under this sub-issue, different options were explored for the presentation of information relating to the performance of structured funds. These are funds which behave in a complicated way, with outcomes determined by a preset formula at the outset (e.g. a return of original capital plus 30% of any upside of an index after five years). For those jurisdictions where such funds are common, regulators have typically required additional illustrative information to be provided to aid investors in considering these funds: the investor testing exercise explored different options for harmonising the presentation of this information.

Sub-Issue 3.4 – Charges Information

Baseline No action [not a viable alternative as Commission required to adopt level 2 measures]

Option 3.4.2: Structured Presentation

Option 3.4.3: Structured Presentation with addition of disclosure of example in cash terms

Under this sub-issue, different options were explored for aiding investors in understanding the cost of a fund. Costs are important points of comparison, as these costs can be a significant drag on final returns yet evidence suggests investors can fail to place a significant emphasis on the information. The investor testing exercise explored different options for addressing these issues.

It is important to be clear that level 1 requires the adoption of implementing measures in relation to a harmonised and standardised disclosure document. For this reasons the costs and impact of harmonisation and standardisation as such should be considered a level 1 issue – and were assessed as part of the level 1 impact assessment. Level 2 focuses rather on the content of the harmonisation, and the key outcomes by which that content are to be assessed relate to consumer comprehension and engagement and capacity to use the information to compare between different UCITS. The efficiency of options in this context relates to the extent to which the content of the option would be complex, costly and difficult to implement.

Sub-issue one has been debated at a general level in relation to the approach taken to harmonising pre-contractual disclosure documents, however the scope for adopting flexibility (option 3.1.3) is extremely limited given the UCITS IV Directive has determined that level 2 requirements shall be adopted that exhaustively harmonise the document. In addition, option 3.1.3 would clearly not be as effective in delivering cross-border and single market benefits, to the extent that these benefits depend on mutual confidence between supervisors and consistency in requirements and it had been concluded that existing flexibility had not gone far enough. Also, option 3.1.3 could potentially be more costly for firms and supervisors (due to reduced legal certainty), whilst could not guarantee investor benefits. Therefore the preferred option is 3.1.2 (this mirrors the solution selected at level 1).

For sub-issue two, option 3.2.3 may be less costly for firms to implement, at least at the beginning, as it is in principle closer to current practice (option 3.2.2 will entail set up costs, IT and possibly consultancy costs, and some record keeping and gathering costs) and may provide for a more sophisticated presentation of risk for more sophisticated investors, consumer testing showed that option 3.2.2 performed better against both engagement and comparison criteria, and at least as well against understanding criteria.[48] The preferred option is therefore 3.2.2.

For sub-issue three, all options proved challenging for investors to use. Option 3.3.2 showed little effectiveness in investor testing. Option 3.3.4 encouraged investor engagement, yet there is evidence investors may misinterpret probability information and were poor in practice in using the information. Further, the methodologies for producing the information would entail significant start up costs, being novel in most EU markets, and CESR did not consider it possible to develop harmonised methodologies, which means this information would not be effective for cross-border comparisons, and differences in approach could undermine mutual confidence and cooperation amongst supervisors. Therefore the preferred option is 3.3.3. However, investor testing showed that there are currently significant limits to the capacity of retail investors to understand and use performance scenario information.[49]

For sub-issue four, while option 3.4.3 tested well with investors in initial testing (improving investors' capacity to make certain defined comparisons), this was not the case when placed in the context of a complete KII mock-up, where investors found the additional information under 3.4.3 more confusing.[50] Therefore, the preferred option is 3.4.2.

ISSUE 3 Summary of analysis

Policy Options	Effectiveness in achieving the relevant objective: Maximise comprehension, engagement and use of document for comparisons			Efficiency
	Comprehension	Engagement	Comparisons	
Sub-Issue 3.1 Overall Approach				
Baseline	0	0	0	0

[48] See for a summary UCITS Disclosure Testing Research Report, pp. 150-5.

[49] Ibid, pp. 135-139.

[50] Ibid, pp. 110-135.

Option 3.1.2: Highly standardised / harmonised document	+	+	++	+
Option 3.1.3:	+/=	+/=	+	=
Sub-Issue 3.2 Risk Information				
Baseline	0	0	0	0
Option 3.2.2: Synthetic indicator	+	+	++	+/=
Option 3..2.3:	+/=	+/=	+/=	+/=
Sub-Issue 3.3 Performance scenario				
Baseline	0	0	0	0
Option 3.3.2:	-	+	-	=
Option 3.3.3: Performance scenarios	+	+	+/=	+/=
Option 3.3.4:	-	+/=	+	+/=
Sub-Issue 3.4 Charges				
Baseline	0	0	0	0
Option 3.4.2: Structured Presentation	+	++	++	+
Option 3.4.3:	+/=	+	+	+

ISSUE 4 Policy Options

Inadequately informed investors on the impact of the merger of a fund in which they invest (4.a) or the conversion of a fund into a feeder or change of the feeder's master UCITS (4.b) (Annex II, section 9)

Option 4.1: No EU action at level 2

This option would mean that the Commission does not use the possibility to harmonise via level 2 how information is to be provided to investors. The status quo would prevail and Member States would be able to continue their national regimes as to how information is provided to investors.

Option 4.2: Promote active communication of UCITS management companies with investors

This option would aim to encourage UCITS management companies to communicate with their investors in a more active way. The corresponding measures could take the form of CESR guidelines (level 3).

Option 4.3: Introduce level 2 measures that would require active communication of UCITS management companies with investors

This option would mean that level 2 measures would impose on UCITS to actively communicate the relevant information to investors. Enough flexibility should be ensured as to how such communication with investors takes place and account should be taken of existing channels/structures in Member States through which investors can be reached.

Option 4.1 would preserve the status quo. Existing national regimes already provide for how information on important changes such as investment strategy or a merger of a UCITS should be provided to existing investors. Some Member States require notification of events or changes to the UCITS to be sent to all unit holders. In other Member States the UCITS notice must be given in a newspaper or other widely-circulate publication where investors are likely to read it; as outlined in the problem section, three broad approaches can be distinguished of holding UCITS shares that can determine the way how investors can and are being contacted or provided with the relevant information. In view of these national approaches and as outlined in the problem section, it could be argued that this issue could be left to national legislation, as a harmonised EU-wide approach would be disproportionate in its impact in some jurisdictions, and the different approaches in place in specific jurisdictions have not been shown to have generated significant investor detriment.

However, one of the guiding principles for the UCITS IV amendments is that the new business opportunities given to the fund industry in Europe are flanked by appropriate investor protection measures. The passive provision of information (representing the status quo in some Member States – option 4.1) relies on investors finding relevant information by themselves, e.g. in a newspaper. This manner, in view of the Commission, does not do much to ensure that all retail unit-holders are aware of a merger or a master-feeder structure and their rights in relation to it. In this case it is very likely that retail investors would not be able to become aware of the information, let alone make an informed judgement.

Moreover, the situation for investors that are confronted with a cross-border merger (**sub-issue 4.a**) needs specific consideration. The rationale behind the requirements of the level 1 text of the Directive is to ensure that unit-holders are able to make an informed judgement as to the impact of the proposed merger on their investment. This objective can however only be achieved if unit-holders concerned are in a position to become aware of the information related to the merger. For retail investors a cross-border merger incurs greater uncertainties than a pure domestic merger, and may make access to relevant information more difficult, increasing potential investor detriment issues. It can be assumed that investors are *prima facie* more comfortable with their domestic law and the arrangements governing their investments in the domestic context than in a cross-border situation – e.g. they may expect an active communication from each UCITS they invest in. Given this, a uniform European-wide regime on the provision of information to investors would give all investors more reassurance about their rights.

With respect to the new master-feeder regime **(sub-issue 4.b)** which refers to both a domestic and a cross-border context, there are similar investor protection concerns. While adopting different requirements for domestic and cross-border structures would create an unlevel playing field, confuse investors, and potentially lead to investor detriment. For these reasons, a harmonised approach based on active communication should also increase investor confidence in this new fund structure and ensure that investors can effectively use their rights as provided for by the level 1 text of the UCITS IV Directive.

Options 4.2 as well as 4.3 address these issues. All management companies would as a result be required (via a non-legislative or legislative means) to inform their investors in an active way. These options would in principle bring about costs for management companies in those Member States where passive provision of information to investors is currently allowed. Both options would on the other hand increase investors' confidence in the new merger and master-feeder opportunities brought about by the UCITS IV, which, in view of the Commission, is a key precondition to the success of the new regime.

In addition, in case of mergers (sub-issue 4.a), these requirements (presented by option 4.2 and 4.3) would, for reasons of subsidiarity, not be applicable to purely domestic mergers, raising some level playing field issues in those jurisdictions in which a passive approach to investor communication is the rule. Given that a passive provision of information (representing the status quo in most of the Member States – option 4.1) would not ensure that retail investors are in a realistic position to use crucial information in relation to their rights, neither level playing field nor costs arguments outweigh, in the view of the Commission, the investor protection dangers raised.

How different would the impact of option 4.2 be compared to 4.3? Pursuing a non-legislative means of achieving the underlying objective does not appear to be a sensible approach mainly for two reasons. Firstly, the desired outcome from both of these options is the same – to ensure that all UCITS management companies actively communicate to investors the relevant information. Both of these options would involve costs for industry for the benefit of the investors. Because industry could not expect any material benefits to incur, it would most likely not adhere to any voluntary standards. Secondly and more importantly, since Member States actually have national legislation that already governs the method for providing information to investors, the practical impact of option 4.2 would require such changes at Member States' level in that they would need to amend their national provisions accordingly if they belong to the group of states that currently allows only for passive way of communicating with investors. One could not expect Member States to promote or encourage their UCITS industry to change their communication with investors against the requirements of their existing domestic regime. As such, option 4.2 would imply the same adjustments and costs as those expected to occur if the level 2 measures are proposed. In that respect the non-legislative option can be disregarded.

In the view of CESR and most of the respondents to the consultation of their advice, the benefits of implementing option 4.3 are not likely to justify the costs and many industry players argue that such measure could actually be counter-productive vis-à-vis the objective that amendments of the level 1 Directive are trying to achieve - to facilitate fund rationalisation and thus decrease existing high costs of managing and administering large number of small funds. Although respondents to the CESR consultation did not provide any data that would substantiate such concerns, in view of the Commission such reasoning can be dismissed when costs and benefits are put into the right perspective.

A UCITS would consider to undertake a merger or to create a master-feeder structure only if it expects that cost savings will be substantial. Potential cost savings include operational savings arising from centralisation of fund management resources into a single team of managers and from further standardisation of processes. These cost savings would be on an on-going basis, and foregone if no fund rationalisation occurs. Against these savings can be balanced the one-off costs incurred when informing unit-holders of the potential impact of the merger or master-feeder structure prior to the event. To give an idea of the possible scale of these costs and savings, the results of a study[51] that was used to support the conclusions of the impact assessment of the UCITS IV Directive estimated yearly potential of costs savings for the industry in the range of EUR 3 to 6 billion as a result of fund rationalisation. If we use the same estimates as in the problem section for assessing the potential number of individual investors concerned, then we could say that 500 mergers and the introduction of 500 master-feeder structures would impact 4 million of investors who would each need to be informed. Considering the more expensive way to provide information (via a letter rather than e-mail), then annual costs to the industry as a total could run to a maximum of around EUR 1 billion. This figure should be discounted however since we consider that around 55% of investors would already be actively provided with information under the status quo. Overall fund managers would then be faced with maximum possible costs of about EUR 400 million.[52]

[51] Invesco (2005). Benefits of an integrated European Fund Management: Cross-border merger of funds, a quick win?

[52] These costs are based on the fact that all information provision would entail preparation of paper letters and sending them by post. Naturally, it can be expected that most of the time electronic means would be used. For more details please refer to Annex II, section 9 and 10.

These estimates need to be considered with caution as they depend on significant assumptions, but they give a broad idea of the most likely ranges in which the costs and benefits emerge.

Industry representatives however argue that particularly disproportionate impact of option 4.3 could emerge in situations where a very small UCITS merges with a bigger one, the latter being the receiving side. They argue that in this case the material impact on the receiving UCITS will be insignificant, however the obligation to provide information to investors of both funds would discourage the merger itself on costs grounds. In this context, it needs to be highlighted that it is the obligation set at level 1 of the UCITS Directive which introduced the obligations that the information related to merger or master-feeder structure shall be provided to all investors. It does not give the Commission any basis for differentiating between the investors of merging and receiving funds. The same applies in respect of master-feeder structures. Moreover, in the view of the Commission, the fact that a receiving UCITS is bigger (in terms of assets under management as well as number of investors) does not automatically imply that the information for the receiving investors in a bigger fund is irrelevant or immaterial. The smaller fund (merging) can for example bring in a new asset class with different risk profile and thus having different investment policy and different fee structure of which investors in receiving fund should in principle be notified. It is also their rights, that are guarded by the level 1 provisions as well as those of the merging UCITS.

The Commission is aware that the practicality and cost effectiveness of such a measure needs to be taken into account. The Commission therefore believes that a new requirement as envisaged by option 4.3, needs to be proportionate. There are three potential dimensions to ensuring requirements are proportionate, which could further diminish the expected/estimated cost impact to the industry:

- **Firstly**, the level 2 measures could envisage a requirement on the UCITS management companies which relates solely to responsibilities towards legal unit-holders, rather than underlying investors (for instance, where retail investors are not direct unit-holders, but instead a nominee is the unit-holder and holds the units on behalf of end-investors). In these circumstances, the relationship between the nominee and the retail end-investor is governed by national law. Therefore, option 4.3 would not need to require a look-through approach to identify the underlying investors; UCITS responsibilities should be to unit-holders, i.e. the persons who legally hold the units or shares of the UCITS, irrespective of whether they hold it on their own or on behalf of underlying end-investors.

- **Secondly**, an overly-prescriptive approach to the provision of information could also raise costs unnecessarily. For this reason, under option 4.3 there should be no prescription that information is to be provided in all cases by mail. Instead, industry should be allowed to make use of all durable media (including e-mail), as appropriate (so long as the media is personally addressed and available to the unit-holder).

- **Thirdly**, the nature of the allocation of responsibilities might be clarified. The key outcome being sought is that investors are informed, and it is not material, in terms of this outcome, who undertakes the communication with the investor. Option 4.3 would not require UCITS to directly inform their unit-holders themselves, but would take due account of the specificities in certain Member States in which UCITS or their management companies, for legal or practical reasons, are unable to directly contact unit-holders. (i) In cases where banks or other intermediaries are the unit-holders themselves, implementing option 4.3 would only require UCITS or its management company to provide the information to the bank or intermediary in its capacity as a unit-holder. Whether and how the unit-holder must inform the end-investors is subject to national law. This approach would also take account of situations when banking secrecy prevents distributors from disclosing the identities of end investors to the UCITS. (ii) In cases where end-investors are the legal-owners but the UCITS or its management company do not have a register of these investors, UCITS should also be able to provide the information by passing it along the chain of entities that connect them with their investors: e.g. on to the depositary which could forward it to the custodians, and on to the bank or the intermediary, etc. In order to be able to use this custody chain, the UCITS may eventually need to accordingly adapt the agreement with the relevant entities in this chain. (iii) Commission analysis suggests that only situation which such an approach would not be able to accommodate is the one where UCITS issue shares in bearer form which are not dematerialised. According to the information provided by Member States, Belgium and the Czech Republic still have cases of UCITS with bearer shares in a materialised form. The direct impact of the option 4.3 in these cases would mean that in these countries, neither the management companies nor any other related entity would be in a position to comply with the principle requirements presented by option 4.3 since this is the only situation under which it is not possible in any way to identify the existing unit-holder. It is however reported that Belgium authorities envisage an obligatory transformation of such shares into a dematerialised form by 31 December 2013. In these cases a possibility of a temporary exemption could be considered to accommodate the impact of the option 4.3

Legislative action at EU level is necessary to ensure an appropriate level of investor protection and to increase investors' confidence in the business opportunities of cross-border mergers and master-feeder structures. Without an appropriate level of harmonisation investors would otherwise face difficulties in uniformly receiving appropriate information when they need it.

Option 4.3 is the preferred option. It goes further than the final advice of CESR which did not foresee any measures to harmonise the method of providing information. However pursuing option 4.3 would likely impact only management companies in those Member States where a passive provision of information is allowed and would not be disproportionate given the expected benefits UCITS would incur as a result of fund rationalisation via a merger or a master/feeder structure.

ISSUE 4 Summary of analysis

Policy Options	Effectiveness		Cost Efficiency
	Ensure adequate investor protection	Remove barriers to EU fund integration	
Option 4.1 No EU action	0	0	0
Option 4.2: non-legislative measures to promote active communication with investors	**-/?**	**-/?**	**-/?**
Option 4.3: legislative level 2 measures for active communication of UCITS management companies with investors	+	+	+/?

ISSUE 5 Policy Options

Ineffective and inconsistent mechanisms for communication between competent authorities in relation to the notification procedure

Option 5.1: No EU action (no level 2 measures)

This option would mean that the Commission does not use the possibility to harmonise via level 2. The status quo would prevail and Member States would be free to adopt their own procedures as to how they deal with the transmission and receipt of the notification file, including for handling problems arising from delays or incompleted submissions.

Option 5.2: Promote standardised protocols and procedures between supervisory authorities for the purposes of electronic exchange of the notification file

This option would aim to encourage relevant competent authorities in Member States to adopt standardised procedures and protocols for the treatment of the notification file once submitted via electronic means, but without creating binding requirements. The corresponding measures could take the form of CESR guidelines (level 3).

Option 5.3: Introduce level 2 measures that would introduce minimum harmonised protocols and procedures to be used by supervisory authorities for the purposes of electronic exchange of the notification file

This option would mean that level 2 measures would impose on Member States relevant authorities certain agreed protocols and procedures when exchanging information for the purposes cross-border notification of UCITS funds. These could be supplemented by additional work by supervisors on further cooperation, e.g. through the development of a centralised notification system under the aegis of CESR.

The old notification procedure rested upon the fact that host authorities conducted ex-ante checks before allowing UCITS to be distributed in their country. As such they had certainty as to the completeness of the file and if any problems arose host authorities were able to deal with them in their own right and on their own initiative. With the new procedure the host authority does not have the right to conduct ex-ante checks. Since there is no ex-ante intervention by the host authority, the home authority will not have feedback or assurances from the host so it can assess whether it has effectively discharged its duties. This situation represents the baseline scenario (option 5.1). Most of the respondents to the CESR's consultation agreed that for the new notification procedure to work the home Member State authority needs to have assurance that it has successfully discharged its duties and that the UCITS can rely on the transmission it has sent so as to begin marketing in the territory of the host Member State. This implies that standardising the new notification procedure might be necessary if the efficiency gains of the new system are to be exploited.

Options 5.2 and 5.3 address this issue, and entail a certain harmonisation, whether voluntary or binding, of procedures and protocols to be established by the supervisory authorities to avoid uncertainties. Uncertainty could arise in particular if for example the home authority has sent an e-mail that failed for technical reasons, or did not include all the relevant documents in the transmission file. Sometimes the deficient transmission could become obvious immediately upon transmission sometimes however problems may not become immediately evident. In such cases, there is a need to clarify procedures and timings for how authorities will coordinate their responses.

For clarity, as was outlined earlier, this impact analysis addresses the procedural steps of the transmission of notification file between relevant supervisory authorities, rather than options for using IT systems to drive further efficiencies. Both options take e-mail exchange as the existing IT standard to be used for electronic transmission.

Option 5.3 seeks a standardised approach among authorities for purposes of a swift and simple notification transmission by setting common standards legislatively. This should ease the process by which authorities implement arrangements between themselves for notifications, including clarifying mutual expectations.[53] Although, the objectives to be achieved by non-legislative means (option 5.2) would be the same as for option 5.3, a non-legislative approach would not be as effective as option 5.3 in ensuring consistent standards and coordination of approach, both issues that have created problems in the UCITS market before. Indeed it was precisely problems in this area that led to the changes to the notification procedure within the UCITS IV Directive itself. The voluntary nature of option 5.2 would imply that some authorities may disregard or disagree on emerging standards which could lead to results that are not far removed from the baseline scenario. In terms of costs, both options 5.2 and 5.3 are likely to have some impact on regulatory authorities but in both cases these would be marginal compared to the impact of Level 1, which requires changes to procedural arrangements that trigger one-off costs. A degree of standardisation of procedures should on an on-going basis reduce costs that arise from Member States interacting with each of their counterparties in a different way. There are no direct costs for UCTIS or their investors in this regards (except to a minimal extent where regulatory costs are passed on by supervisors) as requirements are only on supervisory authorities.

In relation to implementing measures it is worth noting the impact of the proposal for a Regulation establishing a European Securities and Markets Authority and the proposal for amending sectoral legislation 'Omnibus Directive"[54] (also amending UCITS IV Directive 2009/65/EC).[55] The "Omnibus Directive" proposes to replace some level 2 measures by technical standards in the future. The adoption of these level 2 measures – as they are now in the UCITS Directive – does not require the scrutiny of the European Parliament because they cover issues of a purely technical nature. This is the case also with respect to the implementing measures concerning issue 5: the exchange of information and the use of electronic communication between competent authorities for the purpose of notification. After the adoption of the "Omnibus Directive" these level 2 measures will remain valid until the point when the new supervisory authority - European Securities and Markets Authority (ESMA) will consider it necessary to change these upon their own initiative since the Commission would have no more any obligation to propose implementing measures in this particular area.[56] This could become a reality should CESR's work result into finding a more sophisticated IT solution that would be cost efficient and effective compared to the existing one – coordinated standards for e-mail exchange.

Option 5.3 is the preferred option. It provides for a necessary level of certainty and security as to the exchange of the notification file. In order to avoid potential delays it clarifies the role of all actors and the steps that should be undertaken in case of technical failures in the transmission of the file. It is therefore the preferred option, and is in line with the final advice provided to the Commission by CESR.

ISSUE 5 Summary of analysis

Policy Options	Effectiveness		Cost Efficiency
	Encourage savings and eliminate cost duplication	Remove barriers to EU fund integration	

[53] Some authorities already use encryption mechanisms (e.g. use of public and private keys) to ensure notification messages are secure.

[54] http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20091026_576_en.pdf.

[55] http://ec.europa.eu/internal_market/finances/committees/index_en.htm.

[56] See annex II, section 9 for more details on the impact of the new supervisory architecture.

Option 5.1 No EU action	0	0	0
Option 5.2: non-legislative measures to promote the use of standardised procedures and protocols for the exchange of notification files	**-/?**	**-/?**	**-/?**
Option 5.3: legislative level 2 measures introducing harmonised protocols and procedures for the exchange of notification files	+	+	+

6.1. Choice of legal instruments

For the purpose of level 2 implementing measures legislation can take the form either of a Directive or a Regulation.

- **ISSUE 1 and 2 - measures that require scrutiny of the European Parliament**

The retained option seeks maximum possible alignment with the MiFID implementing Directive, so as to limit implementation costs and help ensure a level playing field in the sector. In order to ensure this, the implementing measures for UCITS should also take the legal form of a Directive, so that MiFID and UCITS rules would be able to take the same legal form. This will also allow implementing provisions to be adjusted to the specificities of the particular market and the legal system in each Member State, which was considered necessary for MiFID in this area.

- **ISSUE 3 - measures that require scrutiny of the European Parliament**

The retained options are aimed at achieving the greatest possible degree of consistency in the requirements on the KII across different Member States. Given this, and given the aim of ensuring KII from different jurisdictions are comparable for retail investors, a Regulation is considered the most relevant legislative instrument for these implementing measures. Such an instrument will ensure the consistency of requirements across all jurisdictions.

- **ISSUES 4 and 5**

There are implementing measures that are to be adopted in accordance with the regulatory procedure foreseen in article 5 and 7 of Decision 1999/468/EC, whereas other implementing measures are to be adopted under regulatory procedure with scrutiny set out in article 5a(1) to (4) of that Decision. The former procedure refers to measures that are of a more technical or procedural character, the latter are implementing measures that require scrutiny of the European Parliament. For procedural reasons these two types of implementing measures must be included in separate legal acts.

Issue 4 (the way how to provide information to unit-holders in case of a merger or master-feeder structures) – implementing measures that require scrutiny of the European Parliament

In the interest of clarity and transparency, it seems preferable to limit the number of implementing acts to the UCITS directive. Therefore, the provisions on master-feeder structure, fund mergers and certain matters related to the notification procedure will be grouped into one legal act. These measures seek for as much harmonisation as possible. However, the proposed provisions are likely to interact with national law, such as civil law, corporate law, administrative law or administrative practice. Therefore, the use of a regulation in this area might cause unnecessary conflicts with national laws or practices. In addition, the proposed provisions on master-feeder structures set out principles and define objectives without regulating the subject entirely in order to give managers or Member States the necessary flexibility to apply the relevant provisions in the most efficient way corresponding to the local or individual needs. The objectives of these provisions will therefore be achieved in the most appropriate and efficient way through a Directive. Member State will have some leeway to reflect specific features of national law in the process of transposition. In case of a directive Member State can chose the best options to adapt legal framework in order to achieve expected objectives.

Issue 5 (procedure for electronic exchange of information) – measure that do not require scrutiny of the European Parliament

The new notification procedure envisages the use of standard documents, notably a standard notification letter and a standard attestation. In order to introduce standard documents to be used without alteration across EEA countries, it is necessary to use the form of a regulation. This legal instrument is also proposed for the procedural measures which relate to the electronic exchange of information and supervisory cooperation related to on-the-spot inspections and exchange of information between competent authorities. All these provisions should be applied in a uniform way in order to prevent technical failures or procedural gaps which can only be achieved by the use of a Regulation. This will promote consistent implementation and will introduce uniform standards of cooperation.

In addition for all the issues (3, 4 and 5) the level 1 UCITS Directive does not provide any time limits as to when implementing measures in these areas should be adopted. Where implementing legislation is envisaged it is deemed appropriate in particular to reduce adjustment costs that would stem from different timing of implementing level 2 measures and to propose the adoption of implementing measures in these areas at the same time as the compulsory ones (issues 1, 2 and 3).

6.2. Summary of retained options

Table 3: Summary of issues and preferred options

Issue	Retained option	Instrument
1. Inconsistencies in and inappropriateness of organisation, conduct of business, conflicts of interest rules	Level 2 measures should be aligned with MiFID provisions where appropriate	Directive
2: Inconsistencies in and inappropriateness of Risk management	More detailed/prescriptive principles of risk management and measurement techniques at level 2	
3: Investors unable to make informed investment decisions: disclosures do not engage the interest of investors, are difficult to understand and hard to compare		Regulation
Sub-Issue 3.1 – Overall approach	Highly standardised/harmonised document	
Sub-Issue 3.2 – Risk Information	Synthetic indicator	
Sub-Issue 3.3 – Performance Scenarios	Performance scenarios	
Sub-Issue 3.4 – Charges Information	Structured Presentation	
4: : Inadequately informed investors on the	Active communication of UCITS	Directive

impact of the merger of a fund in which they invest (4.a) or the conversion of a fund into a feeder or change of the feeder's master UCITS (4.b)	management companies with investors	
5: Ineffective and inconsistent mechanisms for communication between competent authorities in relation to the notification procedure	Harmonised procedures between competent authorities	Regulation

6.3. The overall impact of the proposed measures

6.3.1. Entire package cumulative effects

6.3.1.1. Cost impacts

The key cost drivers that impact the level 2 solutions have been identified in the analysis that supported the solutions selected at level 1.

There are however three areas where level 2 implementing measures are likely to have material and significant impact irrespective of level 1 provisions. These are the measures relating to the management company passport, those relating to the risk management processes of companies, and those relating to requirements on the active provision of investor information for cross-border mergers and in relation to certain changes in regards master-feeder structures. It is difficult to estimate the overall impact of the measures in the case of merger and master-feeder structures, as costs will scale with the volume of such business, and it is not clear *a priori* how effective the regulatory regime for these structures will be. In these areas level 2 solutions add significant additional detailed requirements which create additional adjustment costs for certain stakeholders; they also create specific benefits.

The remaining level 2 measures will also have impacts for specific populations – for all funds being sold cross-border (in regards changes to notifications processes) as well as for investors being provided with appropriate and suitable information on which basis they can make investment decisions. Cost impacts in these two areas are mostly originating from requirements of level 1 UCITS Directive.

Table 4: summary of costs

MCP: There are likely to be one-off as well as on-going costs. The preferred solution would minimise implementation and compliance costs for UCITS management companies providing investment services under MiFID. Adjustment costs are proportionately higher the lower the current alignment in any particular Member States with relevant MiFID provisions. It can be very roughly estimated that UCITS industry could face one-off costs in the range of EUR 150-300 million and ongoing costs ranging between EUR 80-250 million.[57] It is expected that only 10% asset managers impacted by the changes would be of a small or medium-size.

[57] It needs to be pointed out that these figures are most likely to be lower when we consider the following factors: (1) it is not possible to account for those management companies that belong to the same group and operate in those Member State that provide for a little or no regulatory alignment with MiFID, (2) it is not possible to account for those management companies that do both MiFID as well as UCITS individual and collective portfolio management and (3) it is not possible to account for those management companies that decided to apply MiFID rules on a voluntary basis.

Risk management: Adjustment costs can be expected on the part of management companies as well as supervisors, tempered by the retention of some flexibility in the preferred solution. Although respondents to CESR consultation did not provide any estimate of compliance costs, available evidence suggest that costs will vary depending on what types of risk identification, management and measurement mechanisms UCITS managers have in place already. It could be estimated that one-off costs and ongoing costs related to the adjustments in companies' risk management structures could be one fourth of those estimated for issues 1, i.e. one-off costs in the range of EUR 35-75 million and ongoing costs ranging between EUR 20-60 million.

Key investor information: Given that level 1 determined the necessity for a harmonised pre-contractual disclosure for retail clients, the costs of harmonisation as such are primarily determined by the level 1 changes; the incremental impact of the specific options chosen for the content and form of the document are by comparison marginal. However, the recently conducted study on the costs and benefits of the proposals provides an indication of the impact of the changes at level 1 of the UCITS Directive. Estimates are that the new requirements may be around 7.5% greater in cost for the industry than the current simplified prospectus.[58]

Merger and master-feeder structures: information to be provided to investors: Respondents to the CESR consultation provided no concrete quantitative data on possible costs of pursuing a harmonised approach (e.g. requiring active provision of information to investors). While the fund structures in scope of this requirements are new, many Member States already require an active communication with investors in all cases of material corporate changes in relation to the fund, such that extending this requirement to new fund structures can be considered to be of most relevant impact in those Member States where a passive communication is currently deemed appropriate. An estimation of compliance costs as regards the preferred option indicates that UCITS industry could be faced with possible costs of about EUR 400 million.[59] These estimates need to be considered with caution but they give a broad idea of the most likely ranges in which the costs and benefits emerge. At the same time, these costs represent the administrative burden of the retained option.

Notification: In terms of costs, the retained option is likely to have some impact on regulatory authorities but this would be only marginal since supervisory authorities would need under Level 1 to put in place procedural arrangements triggering one-off costs. A degree of standardisation of procedures should on an on-going basis reduce costs that arise from Member States having to deal with each of their counterparties in a different manner.

6.3.1.2. Synergies and Trade-offs

(i) Synergies – between measures

As already mentioned in the impact assessment for level 1 changes, there are synergies to be expected as a result of interactions of the different implementing measures, leading to greater overall benefits and reduced overall costs. Indeed, the UCITS IV package has been developed as a whole throughout, with such synergies being considered as part of the policy development process. Such synergies are expected in particular in regards the following issues:

[58] The key findings with respect to quantifiable costs to be borne by the industry as a result of the changes at level 1 can be found in Annex I, section 3.1.

[59] These costs are based on the fact that all information provision would entail preparation of paper letters and sending them by post. Naturally, it can be expected that most of the time electronic means would be used. For more details please refer to Annex II, section 9 and 10.

Notification procedure-KII: the new and swifter notification procedure depends to a certain extent on the KII, in so far as the content of the KII is harmonised and cannot form a basis for disagreements between two Member States as to whether a UCITS can be sold cross-border. The level 2 measures on KII have been designed so as to ensure this outcome.

KII-Fund mergers/asset pooling: KII should play an important role in 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 investors' understanding of how the operation will influence their investment. In the second, it would help the investors' understanding of the implications for them of a double-layered investment.

(ii) Trade-offs between objectives of a measure

Fund mergers/asset pooling: investor protection-fund rationalisation: There are certain trade-offs that can be identified between the main objective of achieving robust investor protection and the one trying to stimulate consolidation of too many small funds via the newly introduced pooling techniques – mergers and master-feeder structures. To reconcile both of these objectives, a proportionate solution is being proposed.

6.3.1.3. Benefits

The overall UCITS IV package is expected to deliver specific competition, efficiency and consumer protection benefits. These are outlined in more detail in the section below on specific impacts. The key benefits and their drivers have already been outlined in the impact assessment for the level 1 measures – increased cross-border activity, rationalisation in the UCITS market, more informed investment decisions with attendant reductions in levels of consumer complaints. As outlined above in relation to costs and discussed below in relation to risks to the delivery of benefits, the quantification of these benefits is extremely difficult, particularly in regards this level 2 impact assessment, which is focused solely on the costs and benefits specific to the options assessed at level 2.

In this regard, for the MCP measures and the merger and master-feeder framework, the benefits are largely driven by level 1 changes and measures rather than the measures at level 2. Nonetheless, the level 2 measures, by improving consistency between the UCITS and MiFID frameworks, should drive down some compliance costs while improving legal certainty and clarity. In regards the provision of information to retail investors in relation to mergers and certain changes to master-feeder structures, better informed investors can be expected to be better able to protect their own interests, increasing confidence in the UCITS market and reducing levels of investor detriment.

For the KII, while the level 2 requirements are central benefits drivers, these benefits are extremely difficult to quantify, for reasons that are examined below in the specific impacts section. As with the information provision relating to mergers and master-feeder structures, the key benefit driver is better informed retail investors – leading to greater confidence in the UCITS market and reduced levels of investor detriment. The scale of any such effects is likely to become most apparent ex post, and so would be a good candidate for further analysis ex post, as can be seen in section 7 below, on monitoring.

6.3.2. Specific impacts:

6.3.2.1. Impacts on SMEs

Certain management companies count as SMEs, – one estimate recently put this at 10% of extant companies. The distribution of these companies is not even across all major UCITS domiciles – they are clustered more in the UK and Ireland.[60] In regards the Management Company Passport provisions (issues 1), the UK has already moved largely towards a MiFID-style regime, so that the consequences for UK-based SMEs of the level 2 measures can be considered relatively low. In addition, for those jurisdictions in which a MiFID-style regime has not yet been established, such as Ireland, the key driver of costs is the movement to a more prescriptive and detailed regime (rather than the replacement of one detailed and prescriptive regime by another), such that implementation costs are ultimately entailed by level 1 changes, not by level 2. Similar impact will have changes envisaged in areas of Management Company Passport that relate to risk management and measurement by companies.

As noted in the competitiveness section, managers should see benefits from the possibility to centralise or domicile in one preferred location/Member State from where they would manage funds. This positive impact should also concern SMEs. The new regime introduced by level 1 requirements should make it less costly for SMEs to enter new markets. As with respect to the direct impact on SME of the alignment with relevant MiFID provisions, here it is assumed that overall SMEs may be less likely to derive certain benefits from harmonisation around MiFID (given that they may not be exposed to different activities / compliance regimes at group level, etc.). However, it should be noted that there are proportionality requirements envisaged under the MiFID framework. It is a principles-driven regime which is designed to adjust to the scale and complexity of business and to the risks raised by that business. In effect, MiFID may offer a good basis for mitigating concerns over impact of harmonisation and on SMEs.

6.3.2.2. Impact for Consumers

Improving consumer protection measures in the UCITS framework are a clear goal of the UCITS IV packaged of changes. The notable elements in the package that are expected to contribute to this are the steps to harmonise and improve organisational requirements on management companies; the steps to ensure consumers are appropriately informed in relation to key events for the new merger and master-feeder structures; and, most importantly, the introduction of the KII.

The consumer research undertaken as part of the policy development process for the KII underlines the expectation that its introduction will contribute to better informed investment decisions by retail investors. While there are important limits on the impact of disclosure requirements on retail investors decision making – as is clear when considering the role of advisors or sellers in that decision making, or when considering the consequences of low levels of financial capability – improved investor disclosures are a necessary pre-requisite for informed decision making. To the extent that decision making outcomes are improved, this will lead to reduced levels of mis-buying, potentially reduced levels of consumer complaints, and a more competitive UCITS market. Assessing the scale of this impact is not possible a

[60] Study done by Zentrum für Europäische Wirtschaftsforschung Gmbh (ZEW): Current Trends in the European Asset Management Industry: found that 90% of managers belong to bigger groups of banks or insurance companies in the EU except in the UK and IRL. Lot 1:http://ec.europa.eu/internal_market/investment/docs/other_docs/report_en.pdf and Lot 2: http://ec.europa.eu/internal_market/investment/docs/other_docs/trends_en.pdf.

priori – *ex post* analysis should be able to clarify the extent to which these outcomes occur, though the timescale for such outcomes may be drawn out.

6.3.2.3. Impacts on supervisors

The package of level 2 implementing measures can be expected to have a material impact on supervisors. New measures for cooperation and coordination of supervisory activity, especially in regards joint supervision in relation to certain cross-border activity, are likely to require structural adjustments by supervisors, and lead to higher staffing levels. However, proportionate measures have been introduced – notably to streamline and clarify communication and to standardise responsibilities – that are designed to ensure smoother cross-border supervision, potentially reducing thereby ongoing costs for supervisors. In addition, the greater supervisory burden can be seen as a necessary step in adopting more effective risk and conduct of business regulation of UCITS, as a direct consequence of lessons learned following the financial crisis.

6.3.2.4. Impacts on competition in the internal market and impacts at national and regional level

It is expected that the package of measures will impact on competition on national markets through supporting a further concentration. However the expected results will not be experienced in the same manner in each Member State.

With the introduction of the possibility for asset managers to centralise or domicile in one preferred location/Member State from where they would manage funds, it is expected that this consolidation would result in lower number of managers operating in the EU which would bring efficiency gains resulting from rationalisation of their operations and we would expect to see more concentration in terms of domiciliation of managers.[61] It is expected that the access of these managers to markets on a cross-border basis will increase, which would lead to an increase in number of managers active (managing funds) in those Member States (i.e. it would increase their market share).

It is also expected that the new framework introduced for mergers and master feeder structures should allow management companies to realise economies of scale that should be passed on to investors – as a result of the expected increase in fund size. It is expected that from the consolidation of small funds, economies of scale in the order of 5 to 15 basis points could be achieved.

6.3.2.5. International aspects

The level 1 impact analysis argued that the proposed package of measures will have an important positive effect on the development of the European fund industry in a global context. Strong levels of investor protection will reinforce the attractiveness of the UCITS brand beyond EU borders, while enhanced efficiency and lower costs will assist UCITS funds in

[61] Some preliminary evidence can be seen from a study conducted by RBC Dexia Investor Services and KPMG, in 2009, http://www.rbcdexia.com/documents/EN/Misc/UCITS%20IV%20report.pdf that shows that 60% of fund managers view the MCP as an opportunity to consolidate and re-locate their core activity/asset management into one Member State. However some fund managers also predict that the consolidation will not happen immediately and that it may be more likely that for example the bigger and more established managers will not withdraw their offices from where they are already present due to other reasons than cost efficiency. They predict that market presence and closeness to the investor will be important criteria that managers will also consider.

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. It was also noted that a more integrated market may act as a magnet for international players wishing to have access to the savings of a pool of 493 million investors. However, a recent study[62] indicates that those asset managers targeting non-EU domiciles would not risk adopting approaches – such as centralising operation in a low cost country as would be expected as a result of well functioning MCP – that might harm the marketability of their UCITS products in key growth markets. These managers feel that cost efficiency gains must not jeopardise distribution.

Since the UCITS framework is only applicable to relevant funds established in the EU and in the European Economic Area (EEA) countries, the proposals will have no direct impacts on other third country financial service providers, whether based in the EU or not, except by means of enhancing the competitiveness of UCITS.

6.3.2.6. Social and environmental impacts

The level 1 impact assessment highlighted no significant social or environmental impacts from the proposals for UCITS IV. The package of measures as a whole may impact on the social domain indirectly. In part this relates to the interconnections between different effects, for instance impacts for consumers and indeed the capital markets can be expected to have wider social significance, for instance by improving the liquidity of those markets, or by ensuring savings are allocated effectively, reducing potential impacts on social safety-nets. More directly, the package of measures can be expected to have some implications for the distribution of employment in the UCITS market itself, by removing barriers to cross-border activity and allowing greater flexibility for management companies in regards their structures and locations. Given the overall impact is expected to be to improve competitiveness and efficiency in the UCITS market, a net expansion in that market can be expected, so the overall impact on employment in so far as these objectives are achieved can be expected to be an expansion in the industry.

6.3.2.7. Administrative burden[63]

The UCITS IV package of measures has been focused on investor protection, market competitiveness and efficiency goals, however the impact of UCITS regulation on administrative burdens has also been of central importance, with a goal of removing unnecessary burdens.

The package delivers a number of mechanisms (as was outlined in the level 1 impact assessment) that can lead to reduced burdens. Notably, greater legal certainty and clarity in regards procedures and harmonisation across different Member States are expected to lead to reduced compliance costs, particularly for funds or management companies operating on a cross-border basis. The simplified and streamlined notification procedure, including electronic delivery, will accentuate these impacts, speeding time to market; the new consistent regime for pre-contractual disclosures across different Member States may also be expected to reduce costs for UCITS sold into more than one jurisdiction.

[62] Ibid: The most preferred location for consolidating assets resulting from cross-border fund mergers, 80% of them favoured Luxembourg, while 33% favoured the jurisdiction of their EU group headquarter. The main reasons for creating Master-Feeder structures by respondents was to enter new target markets or segments and to expand the target investors being served.

[63] See Annex II, section 10 for a full analysis of administrative costs and administrative burden.

The KII cost survey has shown however that overall costs related to pre-contractual disclosure, which are a central element of the administrative burden that can be assigned to level 2 implementing measures in particular, may increase over those for the Simplified Prospectus. (Such costs can however be offset against reduced levels of consumer complaints, improved consumer confidence, and consequently an enlarged and more dynamic UCITS market.)

In addition, the screening of all the draft level 2 measures identified 15 information obligations stemming from the implementing measures of the UCITS IV Directive. The screening revealed that out of the four implementing measures being proposed, only two of them involved additional administrative costs – the implementing Directive in the area of Management Company Passport and the implementing Directive in the area of mergers and master-feeder structures.

As regards the former, 13 concrete reporting obligations were found relevant but only one of them was identified as having a concrete material impact, resulting in administrative costs of around EUR 240.000, all of which is to be considered as administrative burden originating from EU legislation. It needs to be pointed out that the estimated compliance costs originating from the requirements of this implementing Directive in the area of MCP are based on a study that did not further consider in detail the inherent administrative costs. However, since the detailed screening indicates that most of the obligations should not have any material impact on management companies, the estimated compliance costs related to issues 1 and 2 that are presented in the relevant sections of this analysis should be considered as purely compliance costs without any additional administrative burden other that the one identified above.

As regards the latter, 2 concrete obligations were identified and the resulting administrative costs for UCITS industry amounts to around EUR 400 million, all of which is to be considered as administrative burden originating from EU legislation.

As regards the draft implementing Regulation on the Key Investor Information, this regulation does not contain any requirements or obligations that would be relevant for the consideration in respect of administrative costs/administrative burden stemming directly from the requirements of the proposed level 2 legislation.

Finally, the draft implementing regulation dealing primarily with the exchange of information between competent authorities and some aspects of the notification procedure does not contain any requirements or obligations that would be relevant for the consideration in respect of administrative costs/administrative burden.

6.3.2.8. Risks and uncertainties in the options, including potential obstacles to transposition/ compliance; changes over time

The UCITS IV package as a whole has introduced a framework which opens the door to new possibilities for management companies: a passport for the management function, and an ability to use merger and master-feeder structures to rationalise the UCITS market, so as to potentially drive economies of scale.

The structure that has been put in place includes significant measures to ensure supervisory and investor confidence are maintained in the light of these new possibilities. This is inevitably a balancing act between efficiency measures and stability and investor protection measures. It will only be possible to ascertain whether the balance has been struck correctly through careful *ex post* analysis.

Certain risks and uncertainties can however already be highlighted. It is possible that marketing factors (militating for a physical presence in all markets in which UCITS are sold) and tax factors (which may reduce the effectiveness of cross-border mergers) may continue to act as a powerful counterbalances to the removal of barriers to the further development of cross-border business. Further, the balance between flexibility and the harmonisation of detail at the European level, e.g. in regards supervisory cooperation or the arrangements between master and feeder UCITS, can be difficult to strike, and there is always a risk that the level of harmonisation selected serves to stifle rather then enable the further development of the market, as was the case with the MCP. In the case of the MCP which relies on the concept of split supervision and creates a degree of mutual dependency among regulators, a recent study[64] indicates that asset managers in this regard do perceive a real risk of effective 'double supervision'. As not all regulators are equally comfortable with the MCP introduced by the UCITS IV changes, the success of the MCP will depend on how well the regulators cooperate, how far they trust each other and how far the new regulatory framework (including its implementing legislation) is able to achieve emergence of harmonised regulatory practices. In regards risk measurement and management techniques, there is always a danger that market evolution and innovation will outstrip the regulatory framework.

There are certain uncertainties in relation to the proposals for improvements to the KII, as mentioned above under impacts for consumers: there are currently powerful limitations on the impact of improvements to pre-contractual disclosure on consumer outcomes, though such improvements are clearly a precondition for better informed investment decisions. The effectiveness of the KII is also strongly dependent on management companies committing significant resources to developing documents that are understandable and useable by retail investors – including the use of investor testing, as many firms already do in regards marketing material. It is only once the importance of the KII is internalised by firms – where it is recognised as a central document for communicating with investors, rather than a legal document – and appropriate resources committed to ensuring it is written plainly and clearly and works as a communication document, that the KII will be able to achieve its goals. This will also depend, practically, on the continued commitment of national supervisors and the supervisory committees; national supervisors will need to ensure, for instance, effective approaches to the use of plain language and the identification and clarification or explanation of material risks in an investor friendly manner. Given these factors, it is difficult to forecast the evolution of the retail market; nonetheless, it is possible that existing work on improving financial education will combine in its impact with disclosure improvements and the initiative on Packaged Retail Investment Products (PRIPs) so as to build on the changes made in the UCITS IV package.

More widely, risks may emerge in regards the consistency of requirements across the financial services – notably for UCITS for those activities that are variously covered by MiFID, the Prospectus Directive, the insurance Directives and the proposed Alternative Investment Fund Managers Directive. In this regard, the Commission's PRIPs initiative is one direct attempt to mitigate the possible impact of sectoral inconsistencies on outcomes for retail investors.

In regards the evolution of the impact of the UCITS IV package over time, it can be expected that the changes made in this package will take many years to bed down, and so while many costs are likely to be borne up-front, benefits may take longer to emerge.

[64] Study conducted by RBC Dexia Investor Services and KPMG in 2009.

6.3.2.9. Impacts on EU budget

There is expected to be no impact on EU budget.

7. MONITORING AND EVALUATION

Table 5: Monitoring indicators level 1 and level 2

Issue	Indicators for level 1	Source of verification for level 1	Level 2
Management Company Passport	Number of management companies Average fund costs Number of investor protection related complaints	FERI data Industry organisations CESR	Issue 1: progress of regulatory alignment with relevant MiFID rules to be assessed via transposition checks. Level 1 indicators remain relevant. Issue 2: progress of regulatory alignment via transposition check of level 2 measures and assessment of consistency of application of level 3 measures. In medium term – need to conduct **external study** with managers on adjustments of their risk management practices to assess the appropriateness of level 2 (and level 3) measures and to assess the effectiveness of adjustments in supervisory practices.
Key Investor Information	Length of the KII Comprehensibility of the KII Number of investor protection related complaints	Stakeholders' feedback (particularly investors)	Issue 3: Level 1 indicators are relevant also with respect to the impact of level 2 measures. **External study** on Synthetic Risk Indicator: (i) assessment of the effectiveness of this approach for investors, eg. for comparing full range of different UCITS, (ii) economic analysis of related costs and application at fund level, (iii) what impact it had on the market, e.g. on types of fund offered to investors.
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 data Industry organisations CESR	Issue 4: Stakeholder feedback and evidence of investor detriment being reported (complaints). Level 1 indicators remain relevant.
Pooling	Number of master-feeder structures	Industry organisations CESR	Issue 4: same as for mergers

	Average size of the master Average fund costs Number of investor protection related complaints		
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	Issue 5: Given the preferred option did not consider the IT aspect of the new notification procedure, the relevant indicators shall be determined as a final solution emerges, on the basis of CESR's cost-benefit analysis of the appropriate level of sophistication of the IT system that should further facilitate the notification procedure.

In addition and as mentioned in the impact assessment for level 1 changes, the provisions of the amended UCITS Directive could also foresee a formal evaluation of the changes aimed at measuring the number of impacts of the level 1 legislative proposal that are extended as a result of additional level 2 requirements. Such an evaluation could therefore also focus on a more comprehensive quantification of the effects of the Directive amendments. The evaluation could take place four years after the entry into force of the UCITS Directive as time will be needed for number of the new measures introduced to be taken up by the relevant market players.

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1. INTRODUCTION

Key features of the 1985 regulatory framework for UCITS

UCITS are investment funds established and authorised in conformity with the requirements of Directive 85/611/EEC. The UCITS Directive lays down common requirements for the organisation, management and oversight of UCITS funds. The Directive defines a list of eligible assets in which a UCITS fund can invest. It also imposes rules relating to the diversification and liquidity of the fund's portfolio.

The UCITS directive adopted in 1985 has provided the regulatory underpinning for the development of a vibrant and integrated European fund market. This legislation was introduced when the European mutual fund industry was in its infancy. By providing a common harmonised template, before many Member States had introduced disparate legislation of their own, UCITS permitted market participants and authorities across the EU to align on a common 'standard'.

The original UCITS Directive had a double objective. First it sought to create the conditions in which investment funds could be sold across borders; a UCITS-compliant fund, once authorised in one Member State, is entitled to be placed on the market throughout the EU – subject only to notification/registration with the local supervisory bodies. After some initial teething problems, the UCITS passport is now serving as the basis for a high degree of integration in EU fund markets. In a large number of Member States, between 60-80% of the funds which are notified for sale to the retail public are domiciled elsewhere in the EU. 25% of funds are widely marketed across several Member States and these funds are also the most successful in attracting new sales. The relative success of funds domiciled in some specialist fund administration centres has heralded a shift from a multi-domestic market structure – to one which is increasingly concentrated on a few specialist fund administration centres (Luxembourg and French domiciled funds account for over 50% of assets invested in UCITS funds: Dublin has a strong presence in money market funds and non-UCITS funds). Consequently, the European fund market is increasingly a truly integrated market where the 'product' circulates relatively freely.

The 1985 UCITS Directive had a second objective however – it sought to enshrine high levels of investor protection so as to foster confidence in the security and reliability of retail investment funds. The UCITS Directive set out to fashion an investment product in which the types and intensity of risk were circumscribed in order to create a financial product for small and relatively inexperienced retail investors. The desired high level of investor protection was i.a. achieved by imposing prescriptive rules on the composition of UCITS portfolio and governance structures.

Box 1.1: UCITS core regulatory principles

The following constitute some of the **core regulatory safeguards** embedded in the UCITS framework:

Investors are able to liquidate their positions in the fund on a regular (often daily) basis. The relative liquidity of UCITS investments is considered to be an important distinguishing feature to other collective investments where investors are locked in for periods ranging from 6 months (hedge funds, real estate) to 10 years (private equity).

The value of each individual unit/share in fund (Net Asset Value) is valued on a daily basis, based on market valuations of assets where these exists and subject to strong procedural checks. The valuation process is overseen by an independent depositary**.**

The UCITS Directive stipulates very prescriptive rules on portfolio diversification in order to minimize large exposures to individual issuers. Under the current framework UCITS may not invest more than 5% of its assets in transferable securities or money market instruments issued by the same body and 20% in deposits made with the same body. The Directive also sets a cap on the funds' exposure to a counterparty in an over-the-counter (OTC) derivative transaction to 10% of its assets when the counterparty is a bank and 5 % otherwise.

Furthermore, UCITS are **not allowed to grant loans or borrow funds or securities**. Borrowing is only allowed under exceptional circumstances provided such borrowing is temporary. However it is limited to 10% of assets under management of the fund.

UCITS framework provides **separate asset safe-keeping**. The fund must entrust all assets to a depositary, a separate legal entity, for safekeeping. The role of a depositary is very important for the operation of the fund, as it is to oversee the fund's operation and is therefore an essential safeguard of investors' interests.

A further distinguishing feature of UCITS is the inclusion of a positive list of eligible assets in which UCITS funds are allowed to invest. This approach was motivated by the desire to ensure that UCITS invest only in liquid instruments, which are easily transferable and negotiable on active markets. The intuition is to prevent UCITS funds from investing in illiquid assets, given that a portfolio of lumpy assets for which no active secondary market exists could prove difficult to value on a regular and accurate basis, or to offer the required redemption possibilities to investors.

Prohibition on funds investing in precious metals, real estate and other non-financial assets/transferable securities.

UCITS are given wider investment powers in 2001

In order to keep pace with growing financial innovation in financial markets the Directive was amended in 2001. While the core regulatory principles remained largely constant, important adjustments were made to the way in which certain protections are specified, and to the list of eligible assets/investment techniques. These changes significantly altered the mix of investment styles and techniques that are permissible for UCITS funds. This has paved the way for important changes in the nature of EU retail funds, the skills used by fund managers and fund administrators, and the risk-reward combinations available to retail fund investors.[65]

Focus on implementing measures following recast of the UCITS Directive in 2009

The regulatory framework for UCITS as established by Directive 85/611/EEC including its amendments introduced in 2001 has been considered largely successful in delivering an effectively functioning market for funds in the EU, including ensuring the effectiveness of this market for retail investors. UCITS are central to many European households' arrangements for long term savings. They give small investors easy access to professionally managed and diversified baskets of financial instruments at affordable costs.

The success of UCITS as a retail product has been achieved thanks to the imposition of strict rules that ensure the funds are widely suitable for retail investors, notably on the diversification and liquidity of the fund's portfolio. These strict requirements and their effective supervision underpin the fact that UCITS funds enjoy a world-wide reputation as a well-supervised financial product. In recent years, third country sales have accounted for up to 40% of new sales of UCITS funds - primarily from Asia.

Nonetheless, it was has been assumed that the UCITS regulatory framework had reached or could reach a finalised and completed state. Further development work was undertaken, through 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 recommended additional measures to improve the UCITS framework in a number of priority areas. Subsequent research and consultations have confirmed this need for EU level action and have helped in the design of possible solutions, culminating finally in changes to the regulatory framework as adopted in July 2009 (UCITS IV).

The costs and benefits of proposed solutions were examined and tested through a two stage process. 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 identified problems hindering the effective working of the European fund market and analysed the different options for overcoming them. In 2008, a second impact assessment report focused on concrete legislative changes and, in particular, on the different possibilities available for designing these. This report aims to avoid any unnecessary duplication of the work already undertaken. The most relevant information regarding previous impact assessment is presented in table 1 and table 2 below.[66]

[65] For more information, please refer to Annex II, section 7 on risk management.

[66] Impact Assessment for the recast of Directive 85/611/EC is available at http://ec.europa.eu/internal_market/investment/docs/legal_texts/framework/ia_report_en.pdf
Impact assessment for the White Paper on enhancing the single market framework for investment funds is available at
http://ec.europa.eu/internal_market/investment/docs/legal_texts/whitepaper/impact_assessment_en.pdf

Table 1

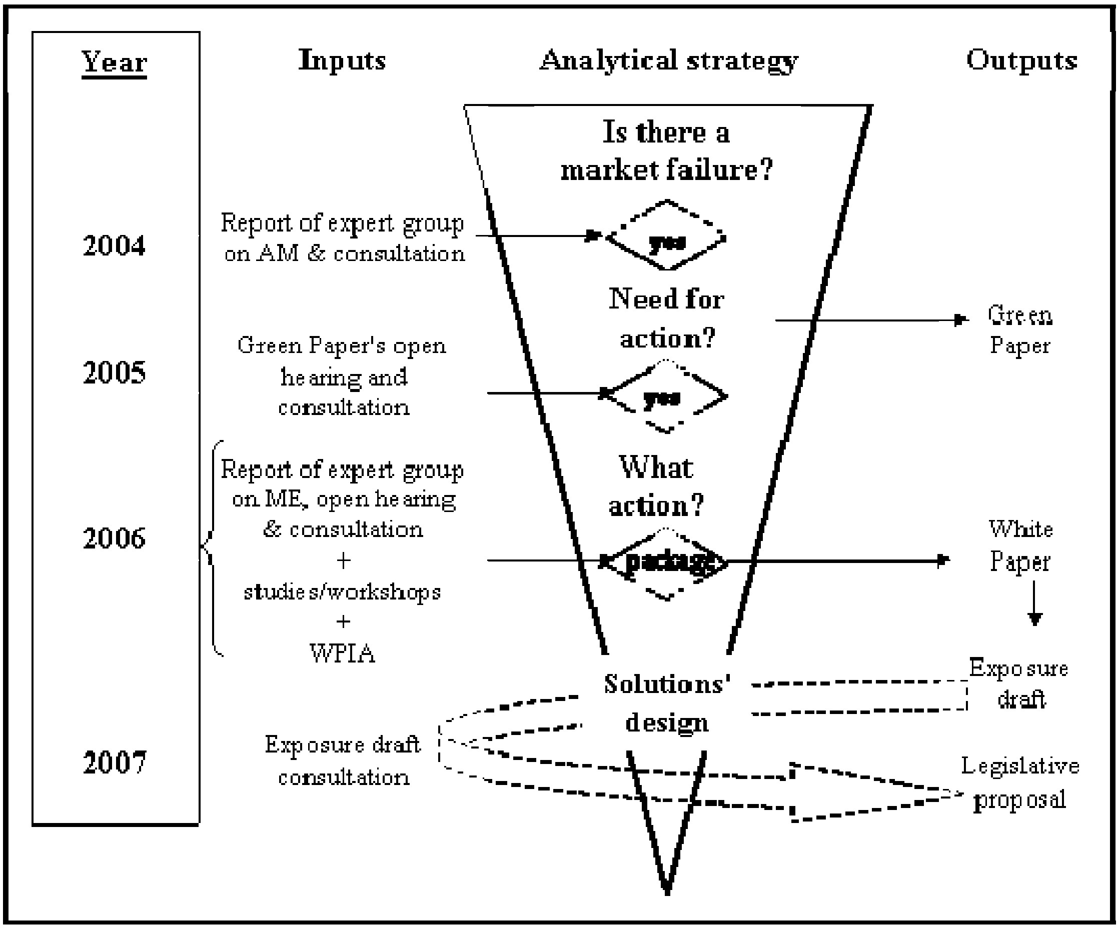

Year
Inputs
Analytical strategy
Outputs
Is there a market failure?
2004
Report of expert group on AM & consultation
yes
Need for action?
Green Paper
2005
Green Paper's open hearing and consultation
yes
What action?
2006
Report of expert group on ME, open hearing & consultation + studies/workshops + WPIA
package
White Paper
Solutions' design
Exposure draft
2007
Exposure draft consultation
Legislative proposal

Table 2: 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;

UCITS IV addresses a number of efficiency concerns, investor protection issues, and practical problems that have been identified in relation to the UCITS industry. These problems arose at a time when UCITS were facing increased competition from other forms of financial product that were also being targeted at retail investors (e.g. unit-linked insurance products and retail structured products). In addition, competition from products originating within other jurisdictions had also started to grow. Given these pressures, it was considered important to limit unnecessary costs and address challenges brought by fast moving innovation in financial markets, so as to ensure an effective level playing field between different products, whilst also working to ensure the standards of investor protection enshrined in the UCITS framework remained best-of-class.

In this context, the new UCITS IV framework is expected to improve the competitiveness of European funds on global markets, the efficiency of the UCITS market within the EU, and the quality and effectiveness of the investor protection standards enshrined within the UCITS framework.

The amendments to the Directive were twofold, firstly in some areas new high-level principles were introduced, some of which were to be complemented by level 2 measures. In other areas, the amendments to the Directive did not change level 1 provisions but existing ones were complemented by the introduction of new implementing powers for the Commission to adopt level 2 measures (see table 3). These new changes that were made to the UCITS Directive were designed in accordance with the 'Lamfalussy' procedure and so the new Directive includes over 19 delegated powers to the Commission to adopt level 2 measures. The level 2 measures deal with the more specific requirements that are the translation into the practice of the principles that are laid down at the level 1 Directive. These measures are prepared on the basis of and supported by advice provided by the Committee of European Securities Regulators (CESR).

One of the benefits of the Lamfalussy procedure is that the new rules can benefit from the input and experience of national supervisors, reflected in CESR's advice. This approach also allows for the possibility of regular updates of the rules since they will not have to be adopted through the full co-decision procedure (i.e. adoption by the European Parliament and Council).

There are four broad issue areas where the Commission is either required to adopt implementing measures, or may choose to do so. In the area of **management company passport** (A), the Commission is obliged to adopt implementing measures by July 2010. In the area of **key investor information** (B), the Commission is obliged to adopt implementing measures, but without a specific deadline. In the areas of **mergers/master-feeder structures** and **notification** (C and D), it is at Commission's discretion to propose level 2 measures, again without a specific deadline.

In light of this, the Commission transmitted a provisional mandate to CESR on 13 February 2009 asking for its technical advice with regard to all these measures. For reasons of consistency and completeness, the Commission decided that all the issues should be dealt with at once so as to enable parallel transposition of appropriate level 1 and 2 measures by Member States. It is to be noted that CESR had in some cases already began work -- for example, in the area of key investor information CESR had started examining issues in 2007, so that its technical advice in this area was already well prepared, and had also informed the Commission’s proposals at level 1. In addition, CESR had already embarked on an extensive mapping of the risk management of UCITS that also provided for a key input to the whole process when working on their advice for level 2.

The problems identified in the impact analysis which underpinned the UCITS IV proposals also naturally underpin any analysis of implementing measures under the UCITS IV framework. However, the financial crisis has highlighted that there are potential areas for further refinement within the UCITS framework which were not identified originally as problems in relation to the original UCITS IV proposals. Observations on these new issues have therefore been incorporated into the impact analysis in such a way that certain new objectives and measures have been identified where failings or insufficient practices of UCITS funds and their fund managers were exposed. It is important to note however that the UCITS IV proposals already addressed certain key issues – such as investor protection issues – that have risen to further prominence following the crisis.

Table 3: Overview of changes that occurred after adoption of UCITS IV

PROBLEM AREA		**UCITS level 1 (611/85/ECC as amended in 2001)**	**UCITS IV level 1**	**UCITS IV level 2**	**Issue in this IA**
A	**Management company passport**	**Organisational arrangements of MC, conduct of rules, conflict of interest**	Level 1 not changed	**Level 2 added**	**ISSUE 1***
		No provisions	**Allocation of supervisory responsibilities when MC manages funds on cross-border basis**	No level 2	
		No provisions	**Definition of set of powers for effective enforcement of their responsibilities**	No level 2	
		Principles of risk management	Level 1 not changed	**Level 2 added**	**ISSUE 2***
		No provisions	**Enhanced authorisation procedure: requirements on MC and depositary to have in place agreement in a cross-border situation**	**Level 2 added**	out of scope*
		Supervisory cooperation	Strengthened concept	**Level 2 added**	out of scope*
B	**Pre-contractual disclosure**	**Simplified prospectus**	**New concept of pre-contractual information to investors**	**Level 2 added**	**ISSUE 3***
C	**Mergers**	No provisions	**Sets a new framework for mergers of UCITS**	**Level 2 added**	**ISSUE 4a***
	Master-Feeder structures	No provisions	**Sets a new framework for master-feeder structures of UCITS**	**Level 2 added**	**ISSUE 4b ***
D	**UCITS fund passport**	**Notification procedure in place for cross-border situations**	**Strengthened concept**	**Level 2 added**	**ISSUE 5 ***
N/a	General obligations of UCITS	Publication of NAV, redemptions, borrowing, etc	No changes	No level 2	N/a
N/a	Investments policy of UCITS	Eligible assets, investment limits, etc	No changes	No level 2	N/a
N/a	Investors complaints	No provisions	**New provision added**	No level 2	N/a

* For purpose of proportionality there are areas for which implementing measures are being considered but they are not subject to the impact analysis. For more details on the content of these measures and justification of leaving it out of the impact analysis, please refer to section 4 of Annex I.

2. The Lamfalussy Process

The 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[67].

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[68] – and the **Committee of European Securities Regulators (CESR)**. The two Committees were set up by Decisions of the Commission on 6 June 2001[69]. 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 as well as CESR seek, *ex-ante*, the views of market participants and end-users (companies, investors and consumers) by way of early, broad and systematic consultation, with particular regard to Level 1 proposals, but also at Level 2.

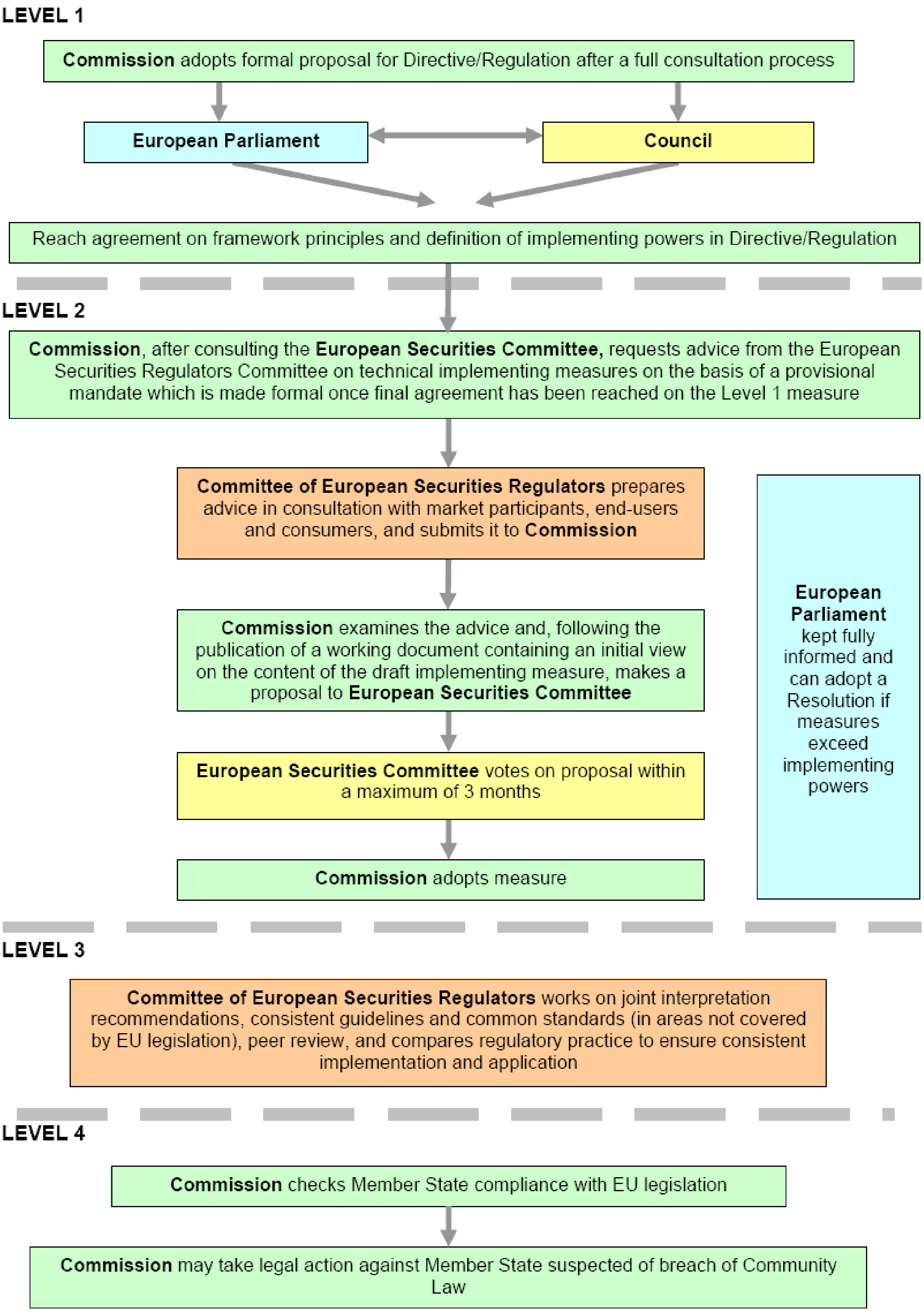
For more details as to how the Lamfalussy regulatory approach is impacted by the newly proposed supervisory architecture in financial services please refer to Annex I, section 6.

[67] 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

[68] 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.

[69] 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).

Table 4: The four-level regulatory approach under the Lamfalussy process[70]



LEVEL 1

Commission adopts formal proposal for Directive/Regulation after a full consultation process

European Parliament

Council

Reach agreement on framework principles and definition of implementing powers in Directive/Regulation

LEVEL 2

Commission, after consulting the **European Securities Committee,** requests advice from the European Securities Regulators Committee on technical implementing measures on the basis of a provisional mandate which is made formal once final agreement has been reached on the Level 1 measure

Committee of European Securities Regulators prepares advice in consultation with market participants, end-users and consumers, and submits it to **Commission**

Commission examines the advice and, following the publication of a working document containing an initial view on the content of the draft implementing measure, makes a proposal to **European Securities Committee**

European Securities Committee votes on proposal within a maximum of 3 months

Commission adopts measure

European Parliament kept fully informed and can adopt a Resolution if measures exceed implementing powers

LEVEL 3

Committee of European Securities Regulators works on joint interpretation recommendations, consistent guidelines and common standards (in areas not covered by EU legislation), peer review, and compares regulatory practice to ensure consistent implementation and application

LEVEL 4

Commission checks Member State compliance with EU legislation

Commission may take legal action against Member State suspected of breach of Community Law

[70] SEC(2004) 1459;

3. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

Date	Item
2005 – October 2006	External study: Current Trends in the European Asset Management Industry
2007 - June 2008	External study: Investment funds in the European Union: comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets
December 2007-January 2009	Study on the costs compliance with the selected FSAP measures
March 2008 - May 2009	External study: Investor testing of possible new format and content for retail fund disclosures – Key Investor Information
February 2009	Commission issues Mandate to Committee of European Securities Regulators (CESR) asking for advice on the content and form of level 2 implementing measures (Part I: Management Company Passport, Part II: Key Investor Information, Part III: Mergers, Master-Feeder and Notification)
July 2009	CESR launches public consultation on draft advice for the Commission on part I and II of the Commission's Mandate
September 2009	CESR launches public consultation on draft advice for the Commission on part III of the Commission's Mandate
October 2009	CESR delivers final advice on Part I and II of the Mandate
4 November 2009	1st meeting of the Impact Assessment Steering Group
March 2009 - November 2009	External Study: Cost and Benefits of the Key Investor Information – testing with UCITS fund managers.
December 2009	CESR delivers final advice on Part II of the Mandate
December 2009	2nd and 3rd meeting of the Impact Assessment Steering Group
November/December 2009	Draft impact assessment report submitted to the Impact Assessment Board (IAB)
February 2010	Approval of the IAB

3.1. Two external studies for retail fund disclosures

3.1.1. Investor testing of possible new format and content for retail fund disclosures – Key Investor Information

This study was proposed so as to provide core evidence to inform the policy development process in regards the Key Investor Information (KII).

It was clear that it would be only possible to develop proposals for the KII that would achieve the outcomes identified – better informed investors by means of improved disclosures to them – on the basis of evidence on how well different disclosure options performed with actual investors. This would need to focus not only on investors' preferences, but also on their understanding of different ways of presenting information. (Investor behaviour and financial capabilities need to be taken into account when considering the possible impacts of different approaches to the presentation of information, since an expressed preference on the part of retail investors cannot be taken to imply always better understanding or use of information by those investors).

The research deployed a range of research methods and research phases – including online testing, telephone interviews and focus groups. It was conducted in tandem with work being undertaken by CESR to develop proposals, so that there was a fruitful interaction and so that the CESR proposals could be refined in the light of the research. The study work was phased in a deliberate fashion so as to enable input to CESR at key points in its own development process. (The options for the presentation of information tested in that study were provided by CESR and developed with the strong input of CESR.)

The final report has been published on the Commission's website.[71] Key findings in the research were its support for a shorter, more simplified document, with a strong focus on plain language and avoidance of financial jargon, and its support for the use of a synthetic risk indicator (as opposed to a purely narrative approach to the provision of information about risk to retail investors). The report underlined the great difficulty that retail investors face in effectively engaging with and using information about investment products.

The researchers concluded that mock ups of the proposed new document (as developed in the concluding phase of the research) would show clear benefits for retail investors compared to existing disclosures, both in terms of engagement (that is, the willingness of those investors to use the document) and in terms of understanding. This supports the arguments in this impact assessment that the proposals for the KII will lead to a reduction in mis-selling and mis-buying of UCITS by retail investors (though it is difficult to quantify the extent of this potential benefit without conducting ex-post analysis following the use of documents in support of actual sales).

3.1.2. Cost and Benefits of the Key Investor Information – testing of the new pre-contractual disclosure document (KII) with UCITS fund managers.

The objectives of the study were to test the proposed new disclosure documents in the form of the KII with representatives of the UCITS industry in order to provide for a cost-effectiveness analysis at the level of fund production, i.e. with fund managers.

[71] http://ec.europa.eu/internal_market/investment/docs/other_docs/research_report_en.pdf

The results provide the Commission with an estimate of the costs (and to a limited degree benefits) that the KII will bring to the UCITS fund industry as a whole. This was carried out with a representative sample of fund managers.

The study concluded that the cost of updating a KII will be in the region of 7.5% more than for the Simplified Prospectus representing 25 million EUR, and that the overall cost of introducing the KII will be in the region of 0.016% of AUM, or 730 million EUR (in so far as there is no further consolidation of the number of funds, and in so far as all existing funds are considered 'open' for new business – this is a very conservative assumption, and the report estimates that the cost figure could be as low as 203 million EUR).

It needs to be highlighted however that these costs are those that stem from the requirements of the level 1 UCITS Directive and are not to be associated with cost impact of the implementing provisions in this area.

The full executive summary of the report:

Survey respondents

This report is based on responses to a survey of managers of UCITS in five countries in July to October 2009. The survey asked for unit costs of preparing and updating KIDs. Managers were asked to estimate the time it would take to prepare and update a KID, and any additional expenditure. Managers were asked to estimate costs on the assumption that accounting and other systems, and a full prospectus were already in place

The number of managers who responded to the survey represents 5% of the European fund industry by number of funds, and 9% by value of funds as at 31st December 2008.

KIDs for most types of funds seem to have similar costs, with the exception of structured funds where additional information is needed and which cost. 11-29% more than other funds. The difference is less marked for updates. There is also some suggestion that KIDs may be slightly more expensive for protected or guaranteed funds

Unit costs

Cost estimates reflected different approaches by managers and different degrees of understanding of what needed to be done. But on average, the preparation of a single KID costs €16000 (€10100 for preparation and dissemination and €5900 for regulatory costs) and the updating of the KID costs €7200 (€5700 for preparation and dissemination and €1500 for regulatory costs). The managers who responded estimated that they would have to prepare 2402 KIDs for their funds, so for the sample as a whole the costs of preparing KIDs amounts to €38.5 million and for updating the KID €17.3 million. The sample represents 5% of the European fund industry by the number of funds, and we can use this information to obtain a total cost estimate for the industry in Europe.

Changeover costs for the industry

The total changeover cost for the industry can be reduced by phasing the introduction of KIDs to coincide with the time when SPs are due to be updated, thus avoiding duplication of effort. Also, it is likely that funds which are no longer seeking to attract new business may not prepare KIDS. If there is flexibility in phasing the introduction of KIDs, and if 10% of funds do not have to prepare KIDS, then the changeover cost for the European industry as a whole would be €389million, of which €203million relates to preparation and €186 million to regulatory costs

To put these figures into context, the net changeover costs of €389million for preparing a KID represent 0.008% of the value of funds as at 31st December 2008.

Update costs

We can compare the costs of updating KIDs against the costs of updating the SP. Managers suggested that updating a KID would cost about 7.5% more than updating the SP. The main reason for this cost difference is that it is possible to prepare a combined SP for a number of funds, but each fund needs one or more KIDs.

On this basis, the additional cost of updating KIDs for the European fund industry once will be about €25 million above the cost of updating the SP. The additional cost of updating a KID represents 0.0005% of the value of funds at the same date.

Management costs of funds vary, from 0.25% to 0.4% of the value of funds for some ETFs with other funds having higher charges. Set against most fund charges, the costs of a KID are relatively small.

Normally, KIDs will be updated once per year. However, if costs change, it may be necessary to update KIDs more frequently. Small changes of less than 5% do not trigger the need for a new KID. We asked managers how often costs would change and the results suggest that if the 5% trigger is maintained, it will be necessary to update many KIDs more than once a year. A trigger level of 10% would generally result in annual updates

Opinions on KIDs

We also asked managers about their views on some key characteristics of KIDS, including the length and complexity and whether the introduction of KIDs would benefit managers. Most managers thought that KIDs were about the right length and complexity, although some expressed reservations that they were too short to contain all the information managers might consider necessary.

There was some support for the suggestion that KIDs would help managers sell cross border, but many managers said that their main sales documents would still differ. As far as other benefits are concerned, most managers see some benefit from KIDS, particularly in respect of investors understanding, although this aspect has been covered by other reports for the Commission. Managers see some benefit in general marketing as well, with 7 out of 20 seeing a marketing benefit.

3.2. Other external studies

This impact assessment has also made use of other studies that were launched earlier and that were not necessarily designed to inform the Commission's work in the UCITS area but were of a more broader scope and focus, including non-harmonised investment funds.

3.2.1. Investment funds in the European Union: comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets

This study has supported and informed the analysis of impacts and problems in particular with respect to risk management of UCITS. Amendments to the UCITS Directive in 2001 increased the range of eligible assets that can be held in a UCITS portfolio to include derivative instruments. The study among others also assessed how UCITS management companies have addressed the new risks in their overall organisational and risk management processes. The study focused on differences in the investment strategies, techniques and the main risk-return features of harmonised funds and retail-oriented non-harmonised funds. The study was based on a broad industry survey. The final report has been published on the Commission's website.[72]

Key findings of the study:

- **Developments in portfolio composition:**

UCITS fund managers make use of the wider investment powers introduced by UCITS III. The portfolio analysis shows an effective use of the wider investment powers in two main forms: UCITS funds of funds and sophisticated funds employing derivatives.

The proportion of UCITS funds in which other UCITS invest has increased significantly.

The use of derivatives by UCITS managers also seems to be more intensive both in terms of type and quantity. The portfolio composition analysis shows that the use of derivatives (which is one of the main areas in which investment restrictions have been relaxed) by UCITS III funds increased and a small proportion of funds invests intensively in these products. That being said, this specific fund population does not seem to significantly outperform other types of UCITS.

The study provides evidence of a higher degree of sophistication for UCITS than for non-harmonised funds. However, over the period under review, sophisticated UCITS do not show a higher level of market risk compared to other (non-harmonised) funds, which use derivatives to a lesser extent (mainly used for short selling). The use of derivatives by UCITS is mainly for hedging purpose. The use to leverage UCITS exposures appears to be limited in the funds surveyed.

Following UCITS III implementation, only a limited number of investment types or strategies are still not permitted in the UCITS universe. This leads PwC to conclude that the UCITS framework provides a high level of flexibility in terms of investment powers. PwC observed in 2007 an increase in the creation of highly sophisticated funds, seemingly due to promulgation of specific/national regulations implementing and specifying the investment restrictions for UCITS III at national level.

- **Performance and market risk:**

[72] PricewaterhouseCoopersEU Services (PwC): Study on "investment funds in the European Union: comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets", 2008: http://ec.europa.eu/internal_market/investment/other_docs/index_en.htm#studies

In terms of performance, PwC's analysis shows that all asset classes (for both UCITS and non-harmonised funds) have experienced at least one year of negative returns, with the exception of real estate funds, whose returns were consistently positive between 2002 and 2006.

Interestingly, within the UCITS environment, when comparing the performance of funds launched before and after 2002 (i.e. launched under the older or the new directive), no significant difference in performance between both categories has been identified. This leads PwC to conclude that UCITS III are not riskier than UCITS I in terms of performance volatility.

When it comes to comparing UCITS with non-harmonised funds, the latter appear to be less volatile than equity UCITS. This said, in general, the low volatility of non-harmonised funds may also be explained by the frequency of NAV calculation (often monthly), which mechanically tends to lower volatility.

- **Other risks:**

Other sources of risk for UCITS stemming from the use of wider investment powers (counterparty, liquidity and valuation risks) are also considered in the study. They are described well in section 5.2 of the report.

In this context, the survey of fund managers aims to identify the current practices in Europe in terms of risk management and to take a closer look at how risks are measured and at what risk management tools have been developed for that purpose. Specific risks are addressed such as: leverage risk; valuation risk; liquidity risk; counterparty risk; and other risk management issues.

A risk particularly prominent for non-harmonised funds is liquidity risk. While UCITS funds must comply with the eligible assets restrictions, non-UCITS funds can invest in non-listed and illiquid assets, which may trigger difficulties to meet redemption demands. Those illiquid assets are also a major source of valuation risk and may raise additional risks in times of market turmoil when it is not possible to sell them at their fair value.

That being said, this survey and face-to-face interviews PwC conducted clearly show that asset managers tend to develop strong risk management procedures before launching new products or entering into complex products.

- **Comparative regulatory analysis:**

With regard to UCITS, PwC identified some differences in the legal framework governing funds, which can have an impact on the portfolio composition of the funds. The main differences are observed for the so-called “trash ratio”. In that context, France appears to be the most flexible country. Luxembourg has adopted a similar position - albeit not to the same extent. **The study identifies a lack of homogeneity in Europe as regards rules for the use of derivatives. Those differences are significant enough to show that the harmonisation of supervision for UCITS is not yet complete**.

- When considering the use of derivatives, the final report notes a lack of homogeneity in Europe, especially in the context of:

- The definition of sophisticated funds and the distinction with non-sophisticated funds;

- The commitment approach for calculating the global exposure on derivatives for non sophisticated funds;

- The parameters imposed by regulators for calculating the Value at Risk;

- The potential limitation of leverage for sophisticated funds;

- And the calculation method of counterparty risks for OTC derivatives.

Furthermore, the final report mentions that as far as a choice of fund domicile is concerned, it is linked more to the availability of specific operational capabilities and the reputation of the domicile, together with the investor familiarity with the vehicle and demand by sales forces.

- **Conclusion**

Even if the regulation allows some UCITS products to implement alternative investment strategies, asset managers always consider the suitability of their funds for retail investors as well as the risk management processes they need before launching such funds.

The study clearly shows that surveyed UCITS managers are satisfied with the flexibility provided under UCITS III.

3.2.2. *Current Trends in the European Asset Management Industry*[73]

This study provides a comprehensive mapping of the main structural trends specific to the UCITS fund industry – in particular, moves towards more open distribution systems, greater functional specialisation, increased industry concentration, and the 'push' and 'pull' factors driving the growth of new products. Although this study has to a larger extent informed the impact assessment for the White Paper on enhancing the single market framework for investment funds from 2006 (the data sets or latest information end with the year 2005), it nevertheless provides a number of useful indicators that will be used as a baseline for the follow up and monitoring of whether the desired objectives of the individual measures have been achieved and to what extent.

The most relevant is the following information with respect to UCITS:

- Market concentration and competition

- Fund distribution channels in Europe

- European market integration

- Efficiency

3.2.3. *3.2.3. Study on the costs compliance with the selected FSAP measures*[74]

In the framework of the **economic evaluation of the Financial Services Action Plan** the European Commission launched two studies: a study to assess the general economic impact of

[73] Lot 1:http://ec.europa.eu/internal_market/investment/docs/other_docs/report_en.pdf and Lot 2: http://ec.europa.eu/internal_market/investment/docs/other_docs/trends_en.pdf

[74] http://ec.europa.eu/internal_market/finances/docs/actionplan/index/090707_cost_of_compliance_en.pdf

the FSAP and – to complement the general assessment – a survey to estimate the cost of compliance with the FSAP measures. Work on both studies commenced in December 2007.

The most relevant source of information used in this impact assessment was the second study **"Survey on the cost of compliance with selected FSAP measures"**. It was based on direct interviews of a sample of companies to obtain their estimates of the costs of compliance with the provisions of selected directives. The study was completed in January 2009.

As regard the focus of the study, the following Directives were considered:

(a) The Prospectus Directive.

(b) The Financial Conglomerates Directive.

(c) The Capital Requirements Directives.

(d) The Transparency Directive.

(e) The Markets in Financial Instruments Directive (MiFID).

(f) The Third Anti-Money Laundering Directive (3AMLD)

The companies that took part in the costing survey were divided into the following financial services sectors:

(a) Banks and financial conglomerates.

(b) Asset managers.

(c) Investment banks.

(d) Financial markets.

The most relevant findings of the study that were used to support the analysis of this impact assessment relate to the quantification of the compliance costs (one-off as well as ongoing) that were connected with implementation of MiFID requirements by asset managers.

Based on a number of structured interviews conducted with about 28 asset managers, the study identified the key cost drivers linked with MiFID implementation as regards one-off as well as ongoing costs per firm that was further specified per firm depending on the geographical origin.[75]

Overall it was found that on-going costs of compliance were lower for any firm that the one-off costs. This was largely a reflection of the need for firms to adapt IT infrastructure, processes and culture upfront, which was no different for the impact of MiFID on asset managers.

[75] One off costs for Asset Managers related to MiFID – please refer to pages 70-79, Ongoing costs for Asset Managers related to MiFID – please refer to pages 108-116. Average one-off and ongoing costs per firm in "Northern" Member States: the UK, Ireland, Germany, Austria, Netherlands, Sweden, Finland and Denmark, "Southern Member States: France, Spain, Italy, Greece, Portugal and Luxembourg, New Member States: Hungary, the Czech Republic, Bulgaria, Malta and Cyprus.

3.3. Content of the Commission's mandate sent to CESR on 13 February 2009 asking for advice on the content of level 2 implementing measures

First part focused on areas where the Commission is under the obligation to adopt implementing measures before the 1 July 2010. They are mainly related to the management company passport (MCP) and cover issues like organizational requirements/conflicts of interest and conduct of business for management companies and risk management. This part covers also other delegations related directly to the issue of MCP, like measures to be taken by depositaries. Other delegations covered are those the Commission considered likely to enhance the proper implementation of the MCP and the proper supervision of UCITS managed on a cross-border basis (e.g. on-the-spot verification and investigation or exchange of information between competent authorities).**Second part** covered implementing powers related to the key investor information (KII). The Commission is under an obligation to adopt implementing measures on the detailed and exhaustive content of the KII (although a deadline was not imposed for this). The Commission may also complement the requirements by adopting provisions on specific conditions to be met when providing KII in a durable medium other than paper or when providing the prospectus in a durable medium. **Third part** concerned other chapters of the new UCITS Directive for which the Commission also received implementing powers: funds mergers, master/feeder structures, and the notification procedure.

4. IMPLEMENTING MEASURES THAT ARE NOT CONSIDERED BY THE IMPACT ASSESSMENT

Table 5: Overview of areas for which implementing measures are being considered but they are not subject of this impact assessment

Problem area	Issue Number	Content
A: MCP	**6**	**Content and format of an agreement** between depositary and a management company of UCITS in a cross-border situation
A: MCP	**7**	Direct sales of UCITS management companies
A: MCP	**8**	Supervisory cooperation (**content of the procedure** to be followed when competent authorities intend to carry out on-the spot verification or exchange of information)
B: Pre-contractual disclosure	**9**	Restrictions to apply in relation to the use of durable media for provision of KII, prospectus to investors
C: Mergers	**10**	**Content and the format of the information** related to merger of UCITS that should be provided to investors
C: Master-Feeder	**11**	**11.a Content and format of the agreement**/internal conduct of business rules between feeder and master UCITS and **11.b Applicable law of the agreement between the master and feeder UCITS**
C: Master-Feeder	**12**	**Content of measures to avoid market timing**
C: Master-Feeder	**13**	**The procedural steps** for approvals in case of liquidation, merger or division of the master UCITS
C: Master-Feeder	**14**	**The content and format of the agreement** between depositaries and auditors
C: Master-Feeder	**15**	**The content of irregularities** the depositary of the master UCITS has to report (including how this reporting shall proceed)
C: Master-Feeder	**16**	**The format of the information** on a conversion into a feeder UCITS or on a change of the master UCITS that should be provided to investors
C: Master-Feeder	**17**	Contribution in kind – **particulars/detailed content of the contribution in kind** that need to be stipulated in the agreement between the feeder and the master UCITS
D: Notification	**18**	Publication of information on laws of UCITS host Member State specifically related to arrangements made for marketing of UCITS in that Member State
D: Notification	**19**	**Content and format of standard notification letter** and standard model attestation of UCITS
D: Notification	**20**	Facilitation of access for the competent authorities of the UCITS host Member State to the statutory information of UCITS (i.e. fund rules,

		key investor information, arrangements made for marketing).

The individual sections below contain detailed justifications for why the impacts of these issues have not been analysed in depth in this impact assessment.

4.1. ISSUE 6: Content and format of an agreement between depositary and a management company of UCITS in a cross-border situation

Issue

Level 1 provisions within the UCITS IV Directive **oblige the management company and the depositary of the fund to conclude an agreement in order for the depositary to be able to fulfil its duties**. These provisions are applicable only in cross-border situations.

The above-mentioned agreement relates to the essential functions of depositaries within the UCITS framework, such as (i) ensuring that the sale, issue, re-purchase, redemption and cancellation of units effected on behalf of a common fund or by a management company are carried out in accordance with the law and the fund rules, (ii) ensuring that the value of units is calculated in accordance with the law and the fund rules, (iii) carrying out the instructions of the management company, unless they conflict with the law or the fund rules, (iv) ensuring that in transactions involving a common fund's assets any consideration is remitted to it within the usual time limits, (v) ensuring that a common fund's income is applied in accordance with the law and the fund rules.

It is evident from the content of these duties that an appropriate information exchange and flow between the depositary and the management company must be in place. This means that it is already the case that depositary must make arrangements to receive all necessary information from management company and that also the latter can and does request information from the depositary on, for example, all the operations it executes.

On a cross-border basis, in situations when a management company chooses to make use of a management company passport, two Member States will be involved with possibly two different implementations of the UCITS Directive in this regard, including additional requirements as allowed by Article 1(7). In this context, it is vital that effective cooperation and information exchange happens between the management company and the depositary. For this reason level 1 of the UCITS IV Directive requires management companies and depositaries working on a cross-border basis to enter into a written agreement governing their relationship, so as to clarify and ensure the necessary flow of information between the two entities and to allow the depositary in particular to perform its functions in the UCITS home Member State.

Justification: level 2 measures would not pose any substantial costs/would not have any major impact.

The co-legislators have considered that, in such cross-border management situations, the Commission should consider whether further specification of the content of such agreement should be regulated via level 2 implementing measures.

Since level 1 provides for the obligation on the part of the UCITS management company to enter into such an agreement with a depositary in cross-border situations, the impact of the possible level 2 measures in this respect appears to be marginal. The main costs/benefits will be generated by the obligation to into such an agreement which is already provided for at level 1. Possible level 2 measures would in practice assess different modes for harmonising the agreement, which will not create any additional or major costs when compared with the impact of the obligation itself provides for by Level 1. For these reasons it is deemed proportionate to remove this issue from the scope of further impact analysis.

4.2. ISSUE 7: Direct sales of UCITS management companies

Issue

Direct sales is one of many issues relating to the interaction between firms undertaking activities governed by the UCITS Directive and activities which are otherwise governed by MiFID. This issue clearly demonstrates an uneven playing field between activities that are subject to MiFID and those that are subject to UCITS, raising underling investor protection issues. UCITS management companies can market and sell their funds cross-border under the UCITS rules, without being subjected to the MIFID regime which applies when MIFID investment firms distribute those same funds. However, the UCITS rules do not provide for any specific sales requirements on management companies who sell directly to investors. This is strong contrast to intermediaries, who are generally covered by requirements (e.g. on appropriateness and on conflicts of interest management) in MiFID. This gap creates investor-protection issues and level playing field issues.

This is also an area where Member States have addressed this issue in different manners (with some seeking to address the level playing field by raising standards for UCITS), leading to further fragmentation of sales rules throughout the internal market.

Direct distribution of both units of UCITS managed by the management company itself and managed by other management companies is a permissible activity of UCITS management companies, as acknowledged in recital 12 of the UCITS IV Directive.

In its advice CESR recommends that 'the activity of direct distribution should be subject to regulatory requirements as it raises regulatory concerns, and that the application of MiFID standards to this activity would ensure a level playing field with intermediated distribution'.

The Commission Services fully share this view. The Commission has already recognised in its Communication of 30 April 2009 on Packaged Retail Investment Products (PRIPs) that the existing rules on the conduct of selling to retail investors of investment products are hampered by 'significant gaps and inconsistencies in approach'. These notably include differences in the rules that apply between direct sales by product originators and sales by intermediaries. The Commission identified the rules on sales as one of the two key regulatory pillars of the PRIPs work and committed itself to developing a new, horizontal legislative approach, drawing on the best of existing requirements. The goal would be ensure that investor protections were appropriate and effective irrespective of the channel the investor chooses to use when buying an investment product. This approach received a strong political support from the finance ministers meeting in the June's 2009 Council.

Justification: issue to be dealt with in another impact assessment (another proposal)

When formulating its advice CESR has recognised this development stating that 'In this context it has to be stressed that work carried out on (launched by the communication of the European Commission of 30 April 2009) will address the issue of direct distribution, as well as disclosure to investors, with a view to ensuring a consistent approach to the retail distribution of substitute investment products, improving investor protection and addressing level playing field'.

Consequently it is deemed appropriate to propose that CESR advice in this area be taken on board in the context of and by means of the PRIPs work.

This suggestion is in line with the Commission commitment to a 'better regulation' principle which discourages frequent regulatory changes, which can increase costs and be a main factor leading to greater legal uncertainty in the market. This is because applying direct sales rules through the UCITS IV framework would not forestall further sequential change to and fine-tuning of these rules as part of the PRIPs initiative (which will seek a horizontal approach to such rules, rather than a sectoral approach).

It is therefore envisaged that appropriate analysis of detailed options for requirements on the direct sales of UCITS will be dealt with in the forthcoming PRIPS impact assessment. For the above reasons the introduction of requirements for management companies on direct distribution/sales will be left out of this impact analysis.

It is not envisaged, from a consumer protection standpoint, that adopting this approach will introduce a significant delay in introducing high standards to the direct distribution activity, since the current aim is to make the PRIPs proposals in 2010 and in addition, the reported proportion of UCITS management companies concerned by this exclusion has in the past couple of years been consistently below 1%.

4.3. ISSUE 8: Supervisory cooperation (content of the procedure to be followed when competent authorities intend to carry out on-the spot verification or exchange of information

Issue

UCITS IV sets out clear responsibilities for Member States' competent authorities where the authorisation and supervision of the fund is being done in a different Member State from the authorisation and supervision of the management company. UCITS IV clearly distinguishes between the provisions that apply to the management company and those which apply at the level of the fund only. This forms a basis for allocating supervisory responsibilities for compliance with the relevant provisions of the UCITS IV Directive.

On the basis of having clearly defined the locus of supervisory responsibilities, the Directive requires that competent authorities are given a defined set of powers (as listed in Article 98 of UCITS IV) necessary for effective enforcement of their responsibilities, domestically as well as on a cross-border basis.

The aim is for competent authorities to thereby be provided with the necessary certainty in order for them to exercise and enforce their powers directly or in collaboration with other authorities. In order for such enforcement to be effective and for the MCP to work well, it was envisaged that additional requirements and procedures would need to be put in place at level 2 to underpin further cooperation and information exchange among competent authorities.

4.3.1. ISSUE 8.a: On-the spot verification and investigation

In this respect, Article 101(1) of UCITS IV provides that *"the competent authorities of the Member States shall cooperate with each other whenever necessary for the purpose of* *carrying out their duties under this Directive or of exercising their powers under this Directive or under national law".*

Furthermore, Article 101(4) of UCITS IV provides that the competent authorities of one Member State may request the cooperation of the competent authorities of another Member State in a supervisory activity or for an on-the spot verification or in an investigation on the territory of the latter within the framework of their powers given by the Directive. These activities can be carried out either by the requested authority itself, by requesting authority or by auditors or other experts. Further modalities and general terms according to which the on-the spot verification can be carried out are provided for in Article 101(5) and Article 101(6) to the whole procedure by setting out clearly conditions under which competent authorities can refuse cooperation or investigation on their territory.

In fact, the concept of cooperation of competent authorities on a cross-border basis including the possibility of on-the spot verification already existed within the UCITS III Directive. However it was not strong enough. UCITS III gave competent authorities powers to carry out on-the spot verification of information that was needed to facilitate their supervision and monitoring of management companies. It was only under UCITS IV when this concept of supervision was strengthen by clearly (i) allocating supervisory responsibilities and (ii) providing competent authorities with a clearly defined set of supervisory and investigatory powers. The procedure of supervisor cooperation and on-the-spot verification was further strengthen in UCITS IV by aligning it with existing provisions and mechanisms in Article 59 of MiFID which are now reflected in Article 101(6) of UCITS.

4.3.2. ISSUE 8.b: Exchange of information between competent authorities

Article 101(2) of UCITS IV provides that "the competent authorities of the Member States shall immediately supply one another with the information required for the purposes of carrying out their duties under this Directive".

Information exchange and cooperation between competent authorities is necessary not only with respect to a well functioning MCP but all activities of a cross-border nature.

Similarly to the issue of on-the spot verification and investigation, similar provisions and implementing powers exist in other financial services directives, in particular the MiFID but also Market Abuse Directive and Prospectus Directive.

Justification for issues 8.a. and 8.b: level 2 measures would not pose any substantial costs/would not have any major impact.

The possibility of proposing implementing measures given to the Commission under Article 101(9) practically means a drawing up of a series of further detailed steps that should be taken by competent authorities to govern their cooperation when initiating an on-the spot verification or investigation. It also entails drawing up a list of essential information that will be necessary in order for requested authorities to be properly informed of the intentions and reasons behind requests for inspections coming from requesting authorities in another Member State. Similarly the possibility of proposing implementing measure given to the Commission under Article 105 of UCITS IV relates to the content of the procedures to be followed by competent authorities in the case of information exchange.

The reasoning for leaving these issues out of the scope of further impact analysis is similar to the one presented for issue 8 above. The provisions setting out the key contours of both procedures have been introduced via level 1 provisions in UCITS IV and thus the greatest impact is assumed at this level. Possible level 2 measures would in practice assess different degrees of additional levels of detail necessary within the key procedural steps that are already enshrined at level 1. In this respect level 2 will not create any additional or major costs when compared with the impact of the provisions that were introduced at level 1 (and greater legal clarity may reduce costs borne by supervisors). For these reasons it is deemed proportionate to remove this issue from the scope of further impact analysis.

4.4. ISSUE 9: Restrictions to apply in relation to the use of durable media for provisions of KII, Prospectus to investors

Issue

In level 1 Articles 75 and 81, the Commission is granted powers to elaborate conditions which might apply to the use of durable media other than paper. Given that durable media are not solely paper, media other than paper can therefore be used for the provision of information to clients.

Investor protection issues arise since the mode of communication between a firm and its clients needs to be appropriate to the needs of those clients. This is an appropriate area in which implementing measures should apply because the modes of communication between firms and clients are subject to ongoing innovation (e.g. the rise of email and other forms of electronic communication) that may need specific handling in the future.

The intention in regards these requirements is also to create a level-playing field with MiFID. The structure of the durable media articles at level 1 was modelled on MiFID, which already contains such provisions.

Justification: level 2 measures would not pose any substantial costs/would not have any major impact.

The options to be considered in regards level 2 measures primarily concern whether or not a level playing field with MiFID should be applied, both to ensure legal consistency but also to ensure consistency in requirements applying to the UCITS and its intermediaries (who will generally be governed by MiFID). The use of electronic delivery by firms is already possible (e.g. as governed by the Dirstance Marketing Directive in Financial Services), and in practice the media used for delivery are either paper or electronic, so little actual costs are expected to be borne by funds. It is expected that alignment with MiFID will have no or marginal impact on consumer protection measures.

4.5. ISSUE 10: Content and the format of the information related to merger of UCITS that should be provided to investors

Issue

UCITS IV introduced a new framework for fund mergers. The new framework is applicable in all circumstances except a purely 'domestic' one (where the merging funds (and compartments thereof), irrespective of their legal form (contractual or corporate), are located in the same Member State (and their units are also distributed on a domestic basis)).

The level 1 provision in this respect requires that information about the merger is supplied to investors concerned once the merger has been authorised by the relevant competent authorities. In addition, the level 1 text sets out all the necessary categories of information that shall be included in the information letter to be provided to investors. This provision is particularly aimed at enabling investors to make an informed judgement on the impact of the merger on their investment. The information letter shall further help investors to make use of the voting rights, if any, and to decide whether they want to stay invested irrespective of the merger or tore-purchase, redeem or convert their units free of charge as provided for by the UCITS IV level 1 provisions.

Justification: level 2 measures would not pose any substantial costs/would not have any major impact

The possibility of proposing implementing measures given to the Commission covers, practically, the additional detail/extension of the key areas of information as enshrined at level 1 which would imply finding the appropriate level of standardisation of the content of the various information categories including the format in which such information should be provided to investors.

The reasoning for leaving this issue out of the scope from further impact analysis is similar to that presented for issues 8 and 10 above: the options for level 2 measures are not expected to create materially different costs for firms or supervisors or impact significantly on the effectiveness of consumer protection. It should be stressed that a key element of the information flow between UCITS and retail clients is the key investor information, which is subject to extensive impact work of the level 2 measures.I In the context of information relating to mergers, relevant key investor information for the merged fund would form a central part of the information flow upon the basis of which the investor would be able to make an informed investment decision.

4.6. ISSUE 11: 11.a Content and format of the agreement/internal conduct of business rules between feeder and master UCITS and 11.b The applicable law in cases of an agreement between the master and the feeder UCITS

Issue 11.a

Another new framework introduced by UCITS IV enables UCITS to create master-feeder structures in order to address the problems and related costs stemming from the sub-optimal fund sizes.

Level 1 provides that a feeder UCITS has to invest at least 85% of its assets in one single master UCITS. As a consequence the fate of a feeder UCITS is much more closely related to that of its master UCITS than the relationship between two 'ordinary' UCITS, including funds of funds.

UCITS IV contains a number of provisions which take account of the dependency of the feeder UCITS on the master UCITS.[76] One of the most important of these provisions is the obligation that the feeder and the master UCITS enter into a legally biding agreement. The agreement shall place the feeder UCITS in a position to obtain in due course all documents and information from the master UCITS which are necessary to enable the feeder UCITS to comply with its duties as a UCITS under the Directive.

Consequently, the competent authorities of the feeder UCITS home Member State may only grant approval of the feeder's investment into the master UCITS, if, among other conditions,

[76] see for instance Article 60, 66(3) and 67.

the agreement and internal conduct of business rules[77] between the feeder and the master UCITS complies with the requirements laid down in Article 60 of the UCITS IV Directive.

Justification 11.a: level 2 measures would not pose any substantial costs/would not have any major impact

The possibility of proposing implementing measures given to the Commission means practically a power to investigate what would be the appropriate degree of standardising/harmonising for the content of such an agreement.

The reasoning for leaving this issue out of the scope from further impact analysis is similar to the one presented for issues 6, 8 and 10 above: the costs and impact at level 2 are marginal in comparison to the costs and impact already created through the introduction of the level 1 changes, since an agreement between the feeder and the master UCITS will need to be struck under the level 1 framework.

Issue 11.b

Another question that could be addressed at level 2 is the legal regime that should govern the agreement between the master and the feeder UCITS, for instance where they are established in different Member States (but also if both of them are located in the same Member State).

Justification 11.b: level 2 measures would not pose any substantial costs/would not have any major impact

The possibility of proposing implementing measures given to the Commission means practically a power to determine what should be the applicable law governing such an agreement.

Again the same line of argumentation is relevant here as well as in the previous cases. The biggest impact on stakeholders has already been assumed by level 1 requirement on master and feeder UCITS that need to enter into a legally binding agreement. This implies that this agreement will need to specify the applicable law as well.

Furthermore, the determination of applicable law is mostly relevant for supervisors and in some instances also for the funds themselves. There is no observable direct link or impact on investor protection. .

As regards supervisors, the choice of applicable law may have implications with respect to the certainty to be achieved from the perspective of competent authorities (when approving the application of the feeder UCITS to invest into the master) as well as with respect to the certainty as to the obligations of the master and feeder UCITS. However and as mentioned above the impact of determining via level 2 measures what applicable law is appropriate would have marginal impact given that it has been assumed by the level 1 changes.

As regards investor protection, the applicable law for the agreement between the master and feeder UCITS does not have direct impact on investor protection. Any investment in a UCITS is subject to the general investor protection provisions of the Directive and these are applicable regardless of where the UCITS fund is located or whether it is a regular UCITS or a

[77] Internal conduct of business rules is required by the level 1 Directive in cases where both master and feeder are situated in the same Member State.

master/feeder UCITS. The applicable law governing the contractual relations between any type of UCITS fund and their investors is the law of the Member State in which the UCITS is domiciled. There is therefore no uncertainty as to the law that applies to the investor and the fund in which they invest.

The law applicable to the agreement between the master and the feeder UCITS does not impinge on this. Overall therefore the impact on key stakeholders is limited.

4.7. ISSUE 12: Measures to avoid market timing

Issue

Since the feeder UCITS has to invest at least 85% of its assets into the master UCITS, the performance of the feeder UCITS depends (at least to a very high degree) on that of the master UCITS. This may create risks of 'market timing' or other arbitrage opportunities in the sense that if the master UCITS publishes its unit price (or NAV) at a certain time before the feeder UCITS, investors may make use of this information for subscribing or buying[78] units of the feeder UCITS for the same day. Those investors would thus be in a competitive advantage compared to other investors in the feeder UCITS who have not taken note of the NAV publication of the master UCITS or who are not that easily in a position to determine to what extent the unit price of the feeder UCITS is determined by that of the master UCITS.[79]

To avoid any forms of 'market timing' or other arbitrage opportunities UCITS IV level 1 obliges the master UCITS and the feeder UCITS to take appropriate measures to coordinate the timing of their net asset value calculation and publication in order to avoid precisely market timing issues and arbitrage opportunities as described above.

Justification: level 2 measures would not pose any substantial costs/would not have any major impact

The possibility of proposing implementing measures given to the Commission means practically a power to investigate/decide whether there should be further specification or clarification of what these appropriate measures should be/contain.

The reasoning for leaving this issue out of the scope from further impact analysis is analogical to the one presented for issues 6, 8, 10 and 11 above: the impact of the level 2 measures is marginal compared to the impact of the level 1 changes, merely giving some consistency in form to agreements and measures that will need to be taken anyway under the level 1 changes.

[78] The term 'buying' means that the investor makes use of other distribution channels (e.g. a stock exchange) than by subscribing units at the UCITS.

[79] Example: A feeder UCITS which is listed at a stock exchange or for which a secondary trading at a stock exchange takes place invests 85% of its assets in the master UCITS and holds 10% liquidity and 5% derivatives. The master UCITS has published its unit price at 2 p.m. CET. The unit price rose by 5% compared to the day before. The feeder UCITS will publish its unit price at 3 p.m. CET. A sophisticated investor seeks exposure to the master UCITS. Since the unit price of the master UCITS has risen by 5%, the sophisticated investor may perhaps not directly invest in the master UCITS, but try to invest before 3 p.m. of that day in the feeder UCITS by finding a seller who is not aware of the prior unit price publication of the master UCITS (and thus of the rise of 5%). The sophisticated investor might thus be in a competitive advantage compared to (i) this seller, (ii) to all other investors which have subscribed units in the feeder UCITS before 2 p.m. (assuming that the cut-off time for subscriptions is before 2 p.m.) and (iii) to retail investors who will not be able to determine which effect the 5% rise of the master will have for the feeder UCITS given that the latter also holds derivatives and ancillary liquidity.

4.8. ISSUE 13: The procedures for approvals in case of liquidation, merger or division of the master UCITS

Issue

As already mentioned above, the fate of the feeder is very closely linked to that of the master UCITS. That is why UCITS IV level 1 provides specific rules in case of a liquidation, merger or division of the master UCITS. Concretely level 1 provides for the following measures:

- **If the master UCITS is liquidated,** the feeder UCITS can no longer stay invested. As a consequence, the feeder UCITS must either find a new master UCITS, convert into an 'ordinary' UCITS or otherwise be liquidated. For both the investment into another master UCITS or the conversion into an 'ordinary' UCITS level 1 text requires an approval by the competent authorities of the steps to be taken by the feeder UCITS.

- **A merger or division of the master UCITS** does not *per se* put into question the master-feeder structures, since the feeder UCITS may stay invested in the master UCITS[80] or another UCITS[81] resulting from the merger or division. The feeder UCITS may however come to the conclusion that the merger or division of the master UCITS is not in the best interest of its own end-investors. In that case the feeder UCITS may either find another master UCITS or convert into an 'ordinary' UCITS. As in the case of liquidation, level 1 text requires the approval of the feeder UCITS competent authorities.[82] To allow the feeder UCITS to make use of these options, the level 1 text further provides that the master UCITS shall answer the feeder UCITS' redemption requests[83] before the merger or division becomes effective. Should the feeder UCITS not make use of any of the options granted by the level 1 provisions, the feeder UCITS will be liquidated.

Justification: level 2 measures would not pose any substantial costs/would not have any major impact

The possibility of proposing implementing measures given to the Commission means practically a power to specify further the procedures that the competent authorities should follow in cases where they are faced with one of the situations/requests as described above. This specification would in particular have to deal with timing issues, i.e. to ensure that the procedure for approval and/or refusal by the competent authorities of the request respects the following the time frames as set out at level 1:

Liquidation of the master UCITS can become effective 3 months after the master UCITS informed all of its unit holders and the competent authorities of the feeder UCITS' home Member States,

Merger or division of a master UCITS shall become effective only if the master UCITS provided all of its unit holders and the competent authorities of its feeder UCITS' home Member State with the relevant information no later than 60 days before the proposed effective date.

The reasoning for leaving this issue out of the scope from further impact analysis is similar to the one presented for issues 6, 8, 10, 11 and 12 above: the material costs and benefits will be

[80] In a merger this is the case, if the master UCITS is the receiving UCITS.

[81] In a merger this is the case, if the master UCITS is the merging UCITS.

[82] In addition also the third option, to stay invested, requires the approval of the competent authorities.

[83] Subparagraph 3 of Article 60(5) gives the feeder UCITS the right to request redemption, but does not explicitly oblige the feeder UCITS to actually request redemption.

crystalised following the level 1 changes, rather than as a consequence of different level 2 options, which are purely technical and marginal in impact.

4.9. ISSUE 14: The content and format of the agreement between depositaries and auditors

Issue

The feeder and the master UCITS can, and if they are established in different Member States, must have different depositaries. They may have the same or different auditors.

The feeder UCITS must have timely access to all relevant information and documents regarding the feeder's investment into the master UCITS. Article 61(1) therefore obliges the feeder UCITS (or its management company) to communicate to its depositary any information about the master UCITS required for the completion of the depositary's duties. Conversely for auditors, the feeder UCITS' auditor may only meet its obligation if it has timely access to all relevant information and documents of the master's auditor.

For this purpose, level 1 text of UCITS IV obliges the depositaries of the feeder and of the master UCITS to enter into an agreement which governs the exchange of information and documents to ensure the fulfilment of their duties.[84] (The same requirement applies for auditors in cases where the master and feeder UCITS have different auditors). Since there is no contractual relationship between both depositaries and both auditors, this agreement forms the legal basis for any information requests on the part of the feeder UCITS' depositary and auditor.

When authorising the feeder UCITS, the competent authorities have to check whether the information-sharing agreement actually enables the depositaries as well as the auditors to comply with their duties

Justification: level 2 measures would not pose any substantial costs/would not have any major impact

The possibility of proposing implementing measures given to the Commission means practically a power to investigate the appropriate degree of standardising/harmonising of the content of these agreements.

The reasoning for leaving this issue out of the scope from further impact analysis is very closely related to issue 11 but the overall reasoning is similar to that presented for 6, 8, 10, 11, 12 and 13 above.

It is provided for in the level 1 text that there has to be an agreement between depositaries and auditors in given situations within the master-feeder structures. The major impact of the fact that agreement shall be in place is at level 1. The impact of specific elaborations on the content of such an agreement is of a negligible impact compared to that of level 1 requirements.

4.10. ISSUE 15: Irregularities which the depositary of the master UCITS has to report

Issue

[84] There is of course no such obligation if the feeder and the master UCITS have the same depositary.

Article 61(2) obliges the master UCITS' depositary to immediately inform the competent authorities of the master UCITS, the feeder UCITS and the feeder UCITS' management company and depositary of any irregularities it detects with regard to the master UCITS which are deemed to have a negative impact on the feeder UCITS. The information available to the competent authorities of the master UCITS shall ensure that they may take appropriate measures to stop irregularities and protect the best interests of all investors of the master UCITS.

Given the strong link between the feeder UCITS and the master UCITS, this information should enable both the feeder UCITS and its depositary to decide on their own measures to protect the best interests of investors (e.g. by obliging the master UCITS to comply with the law, fund rules and the agreement, by claiming damages or by divesting). The master UCITS' depositary is however only obliged to report on those irregularities of the master UCITS which are deemed to have a negative impact on the feeder UCITS. Only then may there be a need for the feeder UCITS or its depositary to act.

Justification: level 2 measures would not pose any substantial costs/would not have any major impact

The Commission may, through level 2 measures, specify which types of irregularities are deemed to have a negative impact on the feeder UCITS.

Since the main obligations that constitute the biggest impact on key stakeholders have been determined already at level 1, it is deemed proportionate to leave this issue out of the scope of further impact analysis. Level 1 requires the master's depositary to inform all stakeholders about any irregularities it detects with respect to the master UCITS. The scope of depositaries' duties is also enshrined at level 1 of the UCITS Directive and thus both of these level 1 requirements represent basic "new" powers in this regard. The impact of the level 1 new powers have been subsumed already at that level, which already requires practical information exchange between the master UCITS depositary and the other concerned entities, including decisions as to what irregularities should be reported. Level 2 measures in this regard would have only minor impact in this respect.

4.11. ISSUE 16: The format of the information on a conversion into a feeder UCITS or on a change of the master UCITS

Issue

Subject to approval by the competent authorities an 'ordinary' UCITS may convert into a feeder UCITS and an existing feeder UCITS may change into a master UCITS or change the master UCITS into which it invests. Both the conversion and the change of master constitute a significant change in the investment strategy and policy of the (feeder) UCITS. This is why Article 64(1) obliges the feeder UCITS to inform all its investors of such a change. The feeder UCITS has to provide this information after the competent authorities approved the conversion/change of master UCITS and at least 30 days before the feeder UCITS starts to invest into the (other) master UCITS. Level 1 also specifies the content of the information that should be provided to the feeder's investors, so as to enable them to make an informed decision on whether to stay invested or to request redemption (available without any charges other than those to cover disinvestment costs pursuant to Article 64(1)(d)).

Justification: level 2 measures would not pose any substantial costs/would not have any major impact

It is at Commission's discretion to decide whether to develop implementing measures on the format in which such information is to be provided to feeder's UCITS investors. Given that content of the information that is to be provided to investors is set at level 1, the format of the information is purely technical issue and does not constitute any major impacts in this regard with respect to adjustments of competent authorities or protection of investors' rights. For these reasons, it is therefore appropriate to leave this issue out of the scope of further analysis.

4.12. ISSUE 17: Contributions in kind – particulars of the contributions in kind that need to be stipulated in an agreement between a feeder and its master UCITS

Issue

When an existing UCITS converts into a feeder UCITS, it may be detrimental to the interests of investors if it must first sell all existing assets and then invest cash in the master UCITS. Likewise a feeder UCITS which wants to or has to change its master UCITS (e.g. because of a liquidation) may wish to save transaction costs by (i) (partially) requesting redemption *in specie* from the old master and (ii) by a contribution in kind into a new master UCITS. In these cases Article 64(4)(b) implicitly allows feeder UCITS to invest into the master UCITS through a contribution in kind, i.e. by a transfer of all or parts of the feeder UCITS' assets to the master UCITS in exchange for units, should the master UCITS agree with it.[85]

Justification: level 2 measures would not pose any substantial costs/would not have any major impact

To protect both the interests of the feeder UCITS and those of other investors of the master UCITS the Commission may adopt implementing measures specifying the procedure for valuing and auditing contributions in kind and the role of the depositary in this process.

This issue at level 2 is considered of negligible impact, given that it is implicitly provided for at level 1 that in case of conversion of UCITS into a feeder there may be (would normally be) a need to value and audit contributions in kind. The major impact stems from the new provisions of level 1 text (which will indeed function to the benefit of investors by reducing unnecessary exposure to costs pursuant to a potentially untimely liquidation of assets). Level 1 requirements have the effect on their own that feeder UCITS that use contributions in kind will need to put procedures in place for handling contributions in kind. For these reasons it is again deemed appropriate to exclude this issue from the scope of further analysis.

4.13. ISSUE 18: Publication of information on laws of UCITS host Member State specifically related to arrangements made for marketing of UCITS in that Member State

Issue

Fund promoters will need to know the rules that govern arrangement made for marketing in each host Member State in which they intend to market their units of a UCITS in order to comply with them. Since there is no ex-ante control or approval of arrangements made for marketing by host authorities, fund promoters must ensure that their arrangements comply with

[85] Article 64(4)(b) does not presuppose that Member States in general allow investors in UCITS to invest through contributions in kind. It however implicitly obliges Member States to enable UCITS which convert into a feeder UCITS or feeder UCITS which change the master UCITS to transfer all or parts of their assets to the (other) master UCITS in exchange for units in the latter.

national rules before their start marketing the units of UCITS. Otherwise they might be exposed to direct precautionary measures to be undertaken by host authorities including penalties.

Level 1 provisions limit the scope of the national rules to be published by host Member State to laws, regulations and administrative provisions which do not fall within the field governed by the UCITS Directive and which are specifically relevant to the arrangements made for marketing of units of UCITS in a host Member State. Level 1 defines also in general terms the basic standards for such publication. The information should be provided in a clear and unambiguous manner, be up-to-date and accessible by electronic means. Moreover, liabilities relating to such publication should be subject to national law.

Justification: level 2 measures would not pose any substantial costs/would not have any major impact

In order to enhance legal certainty as to the scope of such publication the legislator has gave the Commission the discretion to decide on adoption of implementing measures defining the scope of the information covered by the disclosure obligation under article 91(3). This information must cover national provisions specifically related to arrangements made for marketing units of UCITS in a host Member State. In general those provisions regulate matters that are outside the field governed by the UCITS Directive.

The main objective of implementing measures is therefore to establish easy access to applicable national rules for fund promoters. This should help them better prepare for accessing the market, reduce compliance costs and prevent them from unintentional breach of those rules.

The impact of level 2 measures in this regard is again limited since the basic obligation: to include in the notification letter also information on arrangements made for marketing of units of the UCITS in the host Member State, is already provided for as a level 1 requirement. For this reason it is again deemed proportionate to exclude the details or the specificities of the content of such information from the scope of further analysis.

The impact is deemed negligible also from the perspective of how this issue has already been implemented in practice by Member States. The particulars of the scope and way how this information should be provided has been subject of the CESR's guidelines issued in June 2006 (Guideline number 13).[86] Peer review conducted by CESR[87] of the implementation of these guidelines indicate that a great majority of Member States (except 3) fully comply with the guidelines and publish on their websites an overview of the non-harmonised national marketing rules and keep them updated.

[86] CESR in its guidelines of June 2006 has already recommended that Member States publish national marketing rules and other specific national regulations on their website. To this end CESR developed a format of presentation of such information that promoted standardised overview of applicable national provisions of host Member State. See CESR's Guidelines to simplify the notification procedure , CESR/06-120b, http://www.cesr.eu/index.php?page=document_details&from_title=Documents&id=3852

[87] Peer review of the implementation of CESR's guidelines to simplify the notification procedure, CESR/09-1034 published 29/01/2010 at: http://www.cesr.eu/index.php?page=groups&mac=0&id=23

4.14. ISSUE 19: Form and the content of standard notification letter and standard model attestation of UCITS

Issue

Under Article 93(1) the notification letter shall include information on arrangements made for marketing of units of UCITS in the host Member State. This should cover also information on share classes that UCITS intends to market in the host Member State and information on whether units will be marketed directly by a management company of the UCITS under Article 16(1). It must be noted that the notification letter should cover information that is necessary for supervisory authorities of the host Member State to prepare for the on-going supervision of compliance of marketing arrangements with applicable national rules.

Moreover, according to Article 93(2) the notification letter should be accompanied by the latest versions of the funds rules or its instruments of incorporation and the key investor information.

Also, according to article 93(3) authorities of the UCITS home Member State shall enclose to the notification file an attestation that UCITS fulfils the conditions imposed by this Directive. In the view of the Commission, the purpose of this attestation is to certify that a fund notified to the authorities of the host Member State is a UCITS within the meaning of the recast UCITS Directive and complies with the rules subject to supervision by the UCITS home authorities. The scope of attestation does not require the UCITS home authorities to verify compliance of marketing arrangements made by UCITS with applicable national rules of the host Member State.

Lastly, the level 1 requirements specify that the transmission of the notification file shall proceed using electronic means only.

Justification: level 2 measures would not pose any substantial costs/would not have any major impact

Also in this case the Commission has discretion to decide via implementing legislation on the format and the content of a standard model of the notification letter and the attestation document as referred to in Articles 93(1) and 93(3).

The impact of level 2 measures in this regard is again limited since the basic obligation regarding the content of the whole notification file has already been provided for at level 1. For this reason it is again deemed proportionate to exclude the details or the specificities of the content of such information from the scope of further analysis.

The need for the standardised documents has been already expressed by CESR Members in the CESR's guidelines to simplify the notification procedure of UCITS of June 2006. These guidelines included a standardised model attestation (guideline number 11) to market units of UCITS in an EEA Member State (Annex I) and a standardised model notification letter (guideline number 1) to market units of UCITS in an EEA Member State (Annex II).[88]

The impact of level 2 measures is therefore deemed negligible also from the perspective of how this issue has already been implemented in practice by Member States. This is shown

[88] See CESR's Guidelines to simplify the notification procedure , CESR/06-120b, http://www.cesr.eu/index.php?page=document_details&from_title=Documents&id=3852

again in the recently conducted peer review of how the CESR's guidelines[89] have been implemented by individual Member States. With respect to the use of the standardised model of notification letter, nearly all Member States (except one) acting as home Member States recommend their management companies to use the standardised model and from the perspective of host Member States' authorities, here it is reported that all of them accept notification letters based on the model provided for in Annex II of the CESR's Guidelines. With respect to the model authorisation, all Member States in their role as home authorities use the standardised authorisation model as provided for in Annex I of the CESR's Guidelines and when Member States act as host authorities similarly high rate is being observed.

4.15. ISSUE 20: Facilitation of access for the competent authorities of the UCITS host Member State to the statutory information of UCITS

Issue

UCITS IV introduces a new notification procedure; that contains steps to facilitate immediate or rapid access to host markets for a UCITS that is authorised in its home state. The backbone of this new procedure is electronic communication between authorities, to speed up processes and increase their reliability. Since the host authorities will need to have an access to the notification documents and their updates to be in a position to carry out ongoing control of compliance with their rules, the new level 1 provisions also establish that host Member State authorities should have access by electronic means to UCITS' statutory documents (fund rules or instruments of incorporation and their updated versions, the latest version of the key investor information, latest annual and semi-annual reports).

The Commission is empowered to decide whether it is necessary and justified to take further legislative action and harmonise further the particularities of the access of host competent authorities to the statutory information/documents of UCITS.

Justification: level 2 measures would not pose any substantial costs/would not have any major impact

Also in this case the Commission has discretion to decide via implementing legislation on the details that could be necessary to further facilitate and therefore harmonise the particulars as to the electronic access of host authorities to the statutory information/document of UCITS.

The impact of level 2 measures in this regard is again limited since the basic obligation regarding the need for home authorities to provide for an electronic access by host authorities to UCITS statutory documents has already been provided for at level 1. For this reason it is again deemed proportionate to exclude the details or the specificities of such possible measures from the scope of further analysis.

[89] Peer review of the implementation of CESR's guidelines to simplify the notification procedure, CESR/09-1034 published 29/01/2010 at: http://www.cesr.eu/index.php?page=groups&mac=0&id=23

5. OBJECTIVES

The objectives identified at level 1 remain applicable for the relevant level 2 implementing measures, given that the underlying problems also remain the same. However, since the level 2 implementing measures are focused on specific issues, detailed objectives at level 2 can be more focused and delimited.

In addition, the financial crisis has added a fresh dimension to this work. The strategic, specific and operation objectives for level 1 already addressed transparency and stability goals in certain areas (for instance in regards investor protection, integration and level playing field objectives). Following the crisis, however, an explicit focus on an overall financial stability objective is warranted, so as to lay the basis for rebuilding confidence in the financial services through sound management and appropriate investor protection measures.

G1: Efficient EU investment fund market for UCITS	Ensure an integrated and efficient UCITS single market, which it is able to serve all participants (market players and investors alike) in a cost-effective and transparent manner, supported by effective investor protection measures.
G2: Regulatory regime to support robust investor protection measures	Ensure that the UCITS regulatory framework includes robust investor protection measures, so that product offerings are suitable for retail investors and those investors are capable of making informed decisions in relation to the product offerings provided by the fund industry, including comparing between offerings from competing providers. Ensure that risks to investors are identified and appropriately managed.
G3: Elimination or management of risks to financial stability	Ensure this framework supports and provides for enhanced financial stability when examining the financial sector as a whole.

5.1. Specific objectives: general

SP1: Ensure level playing field *.a.1.*	Ensure a single European market for UCITS, in which UCITS are able to compete with one another (and other investment vehicles). Remove barriers (due to inconsistencies in national requirements) to cross-border sales of UCITS and provision of services (including asset management services to UCITS themselves) on a cross-border basis.
SP 2: Encourage industry savings and eliminate cost duplication (regulatory regime to support efficient and	Ensure that the UCITS regulatory framework is able to support an efficient and innovative fund industry attuned to investor needs and able to compete effectively with other investment propositions, keeping administrative burdens to the minimum compatible with other objectives by removing or reducing costs that do not demonstrably promote an integrated and efficient single market or

innovative fund industry)	robust investor protection measures. Ensure that the UCITS regulatory framework enhances the competitiveness of UCITS industry vis-à-vis similar investment products by improving time-to market of UCITS in other Member States.
SP 3: Remove barriers to EU fund integration for UCITS *.a.2.*	Remove barriers (due to inconsistencies in national requirements) to cross-border sales of UCITS and provision of services (including asset management services to UCITS themselves) on a cross-border basis. Ensure effective functioning of techniques for asset pooling on a cross-border basis, so as to raise the efficiency of the UCITS market.
SP 4: Minimize investor detriment	Ensure that the UCITS regulatory framework enshrines effective organisational and risk management structures, and promotes effective supervision. Ensure that investors are in a position to take well informed investment decisions.

5.2. Specific objectives: by problem area

5.2.1. SP A	Allowing increased flexibility in organising the industry value chain by making the Management Company Passport work
SP B	Producing effective investor disclosures by making the pre-contractual disclosures more engaging, comprehensible and comparable for the retail investor
SP C	Allowing funds of optimal size by making the cross-border mergers and master-feeder structures work
SP D	Removing barriers to marketing of funds in other Member States' markets by streamlining the notification procedure

5.3. Operational objectives by issue

ISSUE 1 and 2: Inconsistencies in and inappropriateness of organisation, conduct of business, conflicts of interest rules and risk management for management companies	Ensure that regulatory requirements on (1) organisational arrangements, conduct of business, conflicts of interest and (2) risk management and measurement in different jurisdictions are effective and consistent.
ISSUE 3: Investors unable to make informed investment decisions: disclosures do not engage the interest of investors, are difficult to understand	Ensure disclosures are engaging for investors and effective in providing investors with the information they need in a form that they can use.

and hard to compare)	Ensure greater consistency between pre-contractual investor disclosures produced for different funds.
ISSUE 4: Inadequately informed investors on the impact of the merger of a fund in which they invest (4.a) or the conversion of a fund into a feeder or change of the feeder's master UCITS (4.b)	Ensure that investors investing in UCITS that engage in cross-border mergers or master-feeder structures enjoy appropriate levels of protection and certainty as any other investor investing in regular UCITS fund.
ISSUE 5: Ineffective and inconsistent mechanisms for communication between competent authorities in relation to the notification procedure	Ensure that mechanisms for communication between competent authorities in relation to notification procedure of UCITS are effective, efficient and secure.

6. OVERVIEW OF INITIATIVES IN OTHER AREAS THAT ARE LINKED TO UCITS IV LEVEL 1 AS WELL AS LEVEL 2

6.1. Proposal for a Directive on Alternative Investment Fund Managers (AIFMD)

On 29 April 2009, the European Commission adopted a proposal for a Directive on Alternative Investment Fund Managers (AIFMs). The proposed Directive, an important part of the EU's regulatory response to the financial crisis, aims to create a comprehensive and effective regulatory and supervisory framework for AIFMs in the EU. The Directive will introduce harmonised requirements for entities engaged in the management and administration of Alternative Investment Funds (AIFs). For the purposes of the Directive, these are defined as all funds that are "not harmonised under the UCITS Directive[90]" – i.e. not already covered by EU rules on investment funds. The AIF sector in the EU is relatively large, with around €2 trillion in assets at the end of 2008. It is also diverse: hedge funds, private equity funds, commodity funds, real estate funds and infrastructure funds, among others, all fall within this category. The proposed AIFM Directive is at this stage subject to scrutiny by the European Parliament and Council. It is a proposal for a Directive that does not regulate the product (the AIF) but it is a proposal that contains a set of principles targeting AIF Managers. In any respect, the proposed AIFM Directive covers managers of all funds that are not captured by the existing UCITS IV regulatory framework. Unlike UCITS IV, the proposed AIFM Directive aims at creating a single market framework to the benefit of professional and sophisticated investors.

6.2. UCITS Depositaries

The above mentioned proposal for AIFM Directive aims at organising a regulatory regime for investment products that are mainly structured for professional investors. It imposes a requirement that an alternative fund appoints an institution to safe-keep its assets. The proposed regime applicable to alternative fund depositaries would differ from the UCITS Directive because it details the depositary's safe-keeping duties, and imposes new eligibility conditions upon institutions willing to act as AIF depositaries.

Under the proposed AIFM Directive, AIF depositary liabilities have been strengthened to include an inversion of the burden of proof, and there are clear provisions not only on delegation but also on the conditions under which assets can be entrusted to depositaries outside the EU. These constraints have been introduced in order to provide a better and more transparent regulation of the entity holding the assets and to enable an appropriate level of investor protection in general. As announced by Commissioner McCreevy on 28 May 2009, the level of protection offered by the AIFM Directive proposal should be extended to UCITS funds. It is evidently not appropriate to have a less stringent approach for retail investors than for professional investors.

The Commission considers that depositaries play a very important role in safeguarding the interests of investors who have placed their trust in UCITS by ensuring safe-keeping of the assets held by UCITS as well as a general oversight of their investment policies. The recent Madoff case has confirmed the key role played by these entities as well as the need to make sure they fulfil their responsibilities according to the UCITS Directive. In light of these developments and in parallel with CESR's work mapping the implementation of the obligations

[90] Directive 85/611/EEC on Undertakings for Collective Investment in Transferable Securities (UCITS)

imposed by the UCITS Directive on depositaries, the Commission launched a public consultation that ended in September 2009.

The objective of the consultation paper was to gather evidence and experienced opinion in order to clarify and strengthen the regulation and supervision of UCITS depositaries, with a view to consolidate the level of protection of UCITS investors. It also aimed at playing an important role in identifying and shaping the European response to vulnerabilities emanating from the UCITS depositary sector.

The issues on which the Commission invited views and evidence included:

Depositary's duties: The consultation invited views on whether depositary safe-keeping and supervisory duties should be better harmonised, and if so, how. It sought clarification on the depositary safe-keeping duties for each class of assets that are eligible for being held within a UCITS portfolio, and invited views on whether the existing list of supervisory duties should also be further clarified or extended.

Liability regime: The consultation invited views on how to improve UCITS investor protection if a depositary performs its duties "improperly". To that end, an attempt was made through this consultation to identify when the risks associated with the safe keeping of assets might materialise, especially where assets are entrusted for safe-keeping through a network of sub-custodians. It also sought views on the form of liability regime which would allow investors to adequately mitigate any losses.

Organisational requirements: The consultation invited views on the introduction of rules on organisation and conflicts of interest, based on existing EU rules.

Eligibility criteria and supervision: The consultation asked whether and to what extent eligibility criteria and supervisory rules applicable to the UCITS depositary could be harmonised.

The consultation also covered issues not directly linked to the duties of depositaries but which are particularly relevant for ensuring an increased level of investor protection within the UCITS framework (for example on the valuation process).

Potential further work on depositaries however may be both wider and separate from the issues that can be dealt with under Articles 23 and 33 of the new UCITS IV Directive and such work is therefore outside the scope of this impact assessment. It needs to be highlighted however, that on the basis of the evidence gathered, the Commission will determine whether there is need to enhance existing provisions of the UCITS IV Directive since the consultation concerns issues of the UCITS Directive that have not been subject to changes or amendments leading to adoption of UCITS IV.

Results of the consultation[91] indicated a clear consensus amongst all participants on the fact that maintaining investor confidence in the UCITS label is a high priority. A majority of respondents saw a need to take appropriate action at European level in particular to bring clarity and certainty as regards depositaries duties and responsibilities. In their view there should be a more harmonised approach towards the role of depositaries throughout the EU which would allow for a greater consistency within the EU regulatory framework for investment funds including both UCITS as well as the newly proposed regime for alternative investment fund

[91] Available at: http://ec.europa.eu/internal_market/consultations/2009/ucits_depositary_function_en.htm

sector (currently being negotiated by the co-legislators on the basis of the Commission proposal put forward in April 2009).

Appropriate follow-up work to the consultation, including the identification of a relevant course of action will be clarified separately. A separate impact analysis will be undertaken should changes be considered necessary.

6.3. New supervisory architecture

The proposal for a Regulation establishing a European Securities and Markets Authority and the proposal for amending sectoral legislation 'Omnibus Directive"[92] (also amending UCITS IV Directive 2009/65/EC)[93]

On 23 September the European Commission adopted an important package of proposals for the reform of the European financial supervisory framework in two aspects. First, the European Commission proposed the creation of a European Systemic Risk Board for the detection of risks to the financial system as a whole, with the critical function to issue early risk warnings to be rapidly acted on by national authorities ("macro-prudential supervision"). Second, it was proposed to create a European System of Financial Supervisors (ESFS) for the supervision of individual financial institutions ("micro-prudential supervision"). The ESFS will consist of a network of national financial supervisors working in tandem with new European Supervisory Authorities, created by the transformation of existing Committees for the banking, securities and insurance and occupational pensions sectors[94]. There will be a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA).

The new Authorities in the ESFS will take over all of the functions of the existing committees, and in addition have certain extra competences, including the following:

- Developing proposals for binding technical standards;
- Resolving cases of disagreement between national supervisors, where legislation requires them to co-operate or to agree;
- Contributing to ensuring consistent application of Community rules (including through peer reviews);
- The European Securities and Markets Authority will exercise direct supervisory powers for Credit Rating Agencies;
- A coordination role in emergency situations.

It is necessary to introduce some changes to existing financial services Directives in order for the ESFS to work effectively. Therefore, following the adoption of the legislative package to strengthen financial supervision in Europe, the European Commission proposed to make targeted changes to sectoral financial services legislation. All these changes were grouped in an

[92] http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20091026_576_en.pdf

[93] http://ec.europa.eu/internal_market/finances/committees/index_en.htm

[94] Currently there are three financial services committees at EU level, with advisory powers only: the Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR).

"omnibus Directive" that was adopted by the European Commission on 26 October 2009.[95] The areas in which amendments are proposed fall broadly into the following categories:

- Definition of the appropriate areas in which the Authorities will be able to propose technical standards as an additional tool for supervisory convergence and with a view to developing a single rule book;

- Incorporation in an appropriate manner of the possibility for the Authorities to settle disagreements between national supervisors in a balanced way, in those areas where common decision making processes already exist in sectoral legislation; and

- General amendments which are necessary for the Directives to operate in the context of new authorities for example, renaming the level 3 committees to the new authorities and ensuring the appropriate gateways for the exchange of information are present.

The proposal for the "Omnibus Directive" amends the UCITS IV Directive and gives ESMA the power to propose technical standards that should be endorsed by the European Commission. There are three typological changes proposed:

(i) For some articles of UCITS IV it was decided that ESMA may play a role in developing technical measures. In these cases the technical standards would determine the conditions of application of precise aspects of the level 1 Directive.

The technical standards refer to the following areas: the information to be provided in the application for the authorisation of a UCITS (Article 5(8) of the UCITS Directive; the requirements for the authorisation of the management company and the investment company (Articles 7(6) and 29(5) of the UCITS Directive); the eligible assets (Article 50(4)); the content of the prospectus and periodical reports (Article 69(5)); and, finally, the conditions for the temporary suspension of the re-purchase or redemption of units by the UCITS (Article 84(4) of the UCITS Directive). These areas are out of the scope of the current impact analysis as these articles do not foresee the obligation of the Commission to propose implementing measures.

(ii) For some of the existing implementing powers of the Commission under UCITS IV, the "Omnibus Directive" gives ESMA the possibility to develop draft technical standards in order to further secure uniform application of the implementing measures adopted by the Commission. The technical standards cannot amend or supplement the implementing measures. The powers of ESMA are in this case a means to determine the conditions of application of rules laid down in the implementing measures of the Commission. ESMA technical standards should address matters of pure technical nature and should not involve political decisions. The technical standards, therefore, will not interfere or modify the current Lamfalussy system.

The implementing measures that will be complemented by this change are the following: implementing measures on organisational requirements (Article 12.4 of the UCITS Directive); implementing measures on conduct of business rules (Article 14.3 of the UCITS Directive); implementing measures on information to unit-holders in case of a merger of UCITS (Article 43.6 of the UCITS Directive); implementing measures on risk management requirements (Article 51.5 of the UCITS Directive); implementing measures on master and feeder (Articles

[95] Proposal for a Directive of the European Parliament and of the Council amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC, and 2009/65/EC in respect of the powers of the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

60(7), 61(4) and 64(5) of the UCITS Directive); implementing measures on the Key Investor Information (Article 78(8) of the UCITS Directive). In the context of the issues under scope in this impact assessment, possible future ESMA standards could in particular become relevant under issue 2 – risk management and measurement. The conclusion of the analysis in this area proposes an option that combines principle-based implementing measures for risk management and risk measurement, to be complemented by level 3 guidelines on the parameters and specificities of the risk measurement techniques. Should this framework be adopted, ESMA would then be in a position to propose, should it wish, draft technical standards that would transform these level 3 guidelines into technical standards.

(iii) Finally, the "Omnibus Directive" proposes to replace some level 2 measures by technical standards in the future. The adoption of these level 2 measures – as they are now in the UCITS Directive – does not require the scrutiny of the European Parliament because they cover issues of technical nature (regulatory procedure without scrutiny – so called "non-PRAC measures"). This is the reason why the European Commission considered that these issues would better be addressed by technical standards. Once the "Omnibus Directive" proposal is adopted, the Commission would have no more any obligation to propose implementing measures in these areas. In these cases the technical standards would determine the conditions of application of precise aspects of the level 1 Directive.

The implementing measures that the European Commission proposes to transform into technical standards are the following: measures on notification in Article 95.2 of the UCITS Directive, on-the-spot verifications and investigations (Article 101.9 of the UCITS Directive), and the procedures for exchange of information between Competent Authorities (Article 105 of the UCITS Directive). Of particular relevance here is issue 5, concerning the exchange of information and the use of electronic communication between competent authorities for the purpose of notification. Should the Omnibus Directive be adopted as proposed, ESMA would be in a position to propose new technical standards in this area that would then replace the level 2 measures that are being proposed.

6.4. Remuneration in Financial Institutions

Following the Commission's April 2009 Communication and the two Recommendations on remuneration issues and taking account further developments at EU and international arena[96], the Commission is pursuing a new policy in the area of Remuneration in Financial Institutions. As a result, it makes sure that sound remuneration policy is effectively incorporated within financial institutions' risk management policies. The following areas of financial services sector are impacted and where remuneration policies are being developed:

Capital Requirements Directive (CRD)

The Commission adopted on 13th July a proposal to further amend CRD. The proposal tackles, inter alia, perverse pay incentives by requiring banks and investment firms to have sound remuneration policies that do not encourage or reward excessive risk-taking. This requirement is backed by several principles on sound remuneration policies. Political agreement has been reached at this stage in the Council.

[96] In its 17th September 2009 conclusions, the European Council called for *"the G20 to agreeing on binding rules for financial institutions on variable remunerations backed up by the threat of sanctions at the national level"*. In consequence, agreement reached in the framework of the G20/FSB, entails a direct substantial impact on ongoing work at EU level.

Insurance – Solvency II

The Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) is also looking at this issue of Remuneration in view of providing advice on Solvency II level 2 implementing measures. Relevant advice on sound remuneration policies should be submitted to the European Commission in autumn 2009. It is envisaged that Level 2 implementing measures on the system of governance will include indications on what constitutes a sound remuneration policy. The formal adoption process of the implementing measures is planned for the second half of 2010.

AIFMD proposal

The current proposal as adopted by the Commission on 29 April 2009 does not envisage at this stage any reference to Remuneration policies of AIFM. The Commission is now in the process of negotiating the proposed AIFM Directive in the Council and European Parliament. Given the latest political developments, the Swedish presidency included draft remuneration requirements within their final Presidency draft of the AIFM Directive.

UCITS IV 2009/65/EC

The proposal for new provisions on sound remuneration policies of UCITS management companies have been put forward by the Committee of European Securities Regulators' (CESR) and subjected to the public consultation. See the main text of this Impact Assessment for further discussion of this issue. The Commission noted that sectoral legislation may be required to supplement these steps. To ensure consistent and effective remuneration policies across the financial services the Commission will conduct a separate impact analysis concerning regulatory requirements for remuneration in the UCITS market. This impact assessment will therefore not consider this issue any further.

6.5. Work on packaged retail investment products

The Commission announced in its Recommendation of 30th April 2009 on Packaged Retail Investment Products (PRIPs) its commitment to introduce a new horizontal approach to the regulation of sales and pre-contractual disclosures for these products, so as to ensure a level playing field between different types of investment product offered in the retail market, and so as to ensure consumer protection measures are effective and appropriate. Following the Communication the Commission has focused on developing concrete legislative proposals for this new horizontal approach.

These legislative proposals can be expected to impact on the emerging UCITS IV regime. UCITS funds are by definition PRIPs, and the emerging requirements for a Key Investor Information (KII) pre-contractual disclosure for UCITS were highlighted in the Recommendation as a benchmark for similar requirements for all other PRIPs. The adaptation of this benchmark for other PRIPs and development of a suitable legislative framework for this may well have some impact on the mechanisms by which requirements for UCITS funds are achieved, though would likely have little impact on the substantive content of those requirements as examined in this impact assessment. Work on sales requirements for PRIPs will also address consumer protection and level playing field issues for sales UCITS funds, which is notably relevant in regards direct sales of UCITS by management companies (for further detail on this issue see section 4.2 in Annex I).

PRIPs proposals will be subject to their own impact assessment, which will consider their incremental impact for all stakeholders.

6.6. Work on OTC Derivatives

Derivatives play an important role in the economy but are associated with certain risks. The crisis has highlighted that these risks are not sufficiently mitigated in the over-the-counter (OTC) part of the market, especially as regards credit default swaps (CDS). Since the beginning of the financial crisis, the Commission has been working to address the most urgent of these risks.[97]

The Commission's objectives are to reduce counterparty credit and operational risks, increase transparency and to strengthen market integrity and oversight. **To that end, the Commission proposes a package of actions that will be developed into legislative proposals in 2010 having the following aims:**

To reduce counterparty credit risk, the Commission will (i) propose legislation to establish common safety, regulatory and operational standards for central counterparties (CCPs), (ii) improve collateralisation of bilaterally-cleared contracts, (iii) substantially raise capital charges for bilaterally-cleared as compared with CCP-cleared transactions, and on top of this (iv) mandate CCP-clearing for all standardised contracts.

To reduce operational risk, the Commission will work with industry to promote standardisation of the legal terms of contracts and of contract-processing.

To increase transparency, the Commission will (i) mandate that positions and all transactions are recorded in trade repositories, (ii) regulate and supervise trade repositories, (iii) mandate trading of standardised derivatives on exchanges and other organised trading venues, and (iv) increase pre- and post-trade transparency as part of the upcoming review of the Markets in Financial Instruments Directive (MiFID) for all derivatives markets including for commodity derivatives.

To enhance market integrity and oversight, the Commission will propose clarifying and extending the scope of the Market Abuse Directive (MAD) to derivatives and by giving regulators the possibility to set position limits.

As has been mentioned earlier (see section on risk management in Annex II), UCITS were given extended investment powers that allow UCITS funds to invest in exchange traded and OTC financial derivatives. The most recent evidence also suggests that UCITS are making use of this particular investment possibility and estimates show that the use of OTC derivatives has grown at a rate 10% per annum since the implementation of UCITS III Directive in 2001.

The increased used of derivatives increased exposure of UCITS to new asset classes and brought about new sources of risks to UCITS, including counterparty risk, settlement risk and other operational risks.

[97] On 3 July 2009 the Commission adopted a Communication on ensuring efficient, safe and sound derivatives markets. On 20 October, the Commission adopted a second Communication that sets out the future policy actions the Commission intends to propose to increase transparency of the derivatives market, reduce counterparty and operational risk in trading and enhance market integrity and oversight. (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0563:FIN:EN:PD)

The objectives of the future legislative framework governing OTC derivatives should therefore positively impact on the various risks UCITS funds are exposed to. The issues that are linked to OTC derivatives within the work on level 2 measures for UCITS would however not be subjected to changes having regard the proposed potential measures/their objectives for the OTC derivatives as outlined above and in the latest Commission Communication.

ANNEX II

7. AREA A: Management Company Passport

7.1. General background to problem area

The first problem area relates to unintended inefficiencies in the value chain in the UCITS market. UCITS IV introduces a more flexible regime so as to enable a more efficient and effective organisation of the industry's value chain. This has been done by creating new provisions that enable the practical use of the management company passport (MCP).

The impact assessment accompanying the UCITS IV level 1 package concluded that there were some material uncertainties over the impact of different options for delivering these benefits, and it was agreed to explicitly consider the policy approach to adopt during the co-decisions process. The main uncertainties related to the possibility of ensuring an effective allocation of responsibilities between home and host Member States' supervisors and on the information flows that would need to be established between the different actors concerned (supervisors, fund, management company, depositary) to ensure effective on-going supervision. Another key issue was to define effective cross-border enforcement mechanisms to deal with breaches of rules governing the fund. If there was not sufficient clarity on the allocation of responsibilities, or indeed a lack of effectiveness in overall supervision as a result of split responsibilities or breakdowns in communication between supervisors, then, particularly in the context of the current financial turmoil, such regulatory failure that could have significant effects for ordinary savers.

The Commission also considered that it was important that any new mechanisms required to ensure the proper supervision of funds managed on a cross-border basis should not lead to disproportionate compliance costs and complexity for business operators. If new management opportunities were accompanied by burdensome procedures or heavy regulatory requirements, they would bring little gain to fund managers and investors, reducing the capacity of the selected solution to address the original problem (lack of flexibility in the UCITS value chain).

The impact assessment for UCITS IV level 1 concluded that practical solutions to these concerns had not yet crystallised, yet recognised at the same time that further work might succeed in finding an effective solution. In parallel with the finalisation of the level 1 impact assessment the Commission therefore asked CESR for its advice on robust yet effective solutions to the identified challenges.

CESR members were pragmatic in identifying solutions necessary for establishing a well functioning MCP,[98] and on this basis the co-legislators opted to use the UCITS IV framework to clearly delimit the respective responsibilities of competent authorities where the authorisation and supervision of a fund is being done in a different Member State from the authorisation and supervision of its management company. The new framework clearly distinguishes between provisions that apply to the management company and those which apply at the level of the fund only, so that **supervisory responsibilities** for compliance with the relevant provisions of the UCITS IV Directive can be clearly allocated.

Competent authorities were also given a defined set of powers (as listed in Article 98 of UCITS IV) necessary for the effective enforcement of their responsibilities, both domestically and on a cross-border basis. In addition, the level 1 text established a framework for necessary supervisory

[98] CESR/08-867, http://www.cesr-eu.org/index.php?page=document_details&from_title=Documents&id=5367

cooperation and information flows between the different actors concerned (supervisors, fund, management company, depositary), so as to ensure effective on-going supervision. Lastly, the text established a requirement for cross-border enforcement mechanisms to deal with breaches of the rules governing the fund.

Focus at level 2

In the context of the changes agreed to facilitate a MCP, the Commission is obliged to develop level 2 implementing measures to further harmonise the regulation of the general characteristics of management companies, in particular their organisational structures, handling of conflicts of interest and general conduct of business. It was considered that such harmonisation would provide a necessary basis for greater integration in supervisory practice, thereby supporting the greater freedoms provided for by means of the MCP. In addition, the Commission is obliged to introduce implementing measures to further harmonise management companies' risk management processes. Finally, implementing legislation may be proposed, subject to justification, to facilitate supervisory cooperation and the efficient development of agreements between depositaries and management companies in cross-border situations.

The key challenge in developing these implementing measures is to maintain the balance between market efficiency, effective supervision of the market and the delivery of consistently high investor protection standards – matching, at level 2, the balance sought and struck by the co-legislators at level 1

7.2. Background to the problem of ISSUE 1: Organisational requirements, conflict of interest and conduct of business rules for management companies

In order to facilitate the development of mutual confidence between regulators, the Commission is obliged by the co-legislators to put in place implementing measures that will harmonise the regulation of management company functions.

UCITS level 1 provisions in these areas remain unchanged following the adoption of UCITS IV. Instead, the framework has been changed to require level 2 measures to support the existing framework at level 1.

The level 2 measures foreseen address the organizational and operational activities of the management companies, including their broad conduct of business, prevention of conflicts of interests and management of risk, in so far as they are engaged in collective portfolio management. These implementing measures cover issues which the co-legislators have considered essential for ensuring that investors in funds that are managed on a cross-border basis are not exposed to additional operational risk or lower standards of investor protection in comparison to fund structures managed domestically. They should also provide conditions for a level playing field between Member States and management companies, and so reduce opportunities for regulatory arbitrage between Member States that could undermine the achievement of a high level of investor protection.

Under the current regimes broadly applying to asset management activities, divergent regulatory standards have developed that are applicable to similar activities – divergence exists both at the level of the supervision of UCITS standards by Member States, but also at the level of the standards applying to collective portfolio management (UCITS, in this case) and to individual portfolio management (MiFID).

The original UCITS Directive set out high level principles for management companies as regards their organisation, how they should conduct themselves and on the management of conflicts of interests. However, with the introduction of MiFID (including its implementing legislation) an uneven playing field has arisen between activities governed by UCITS requirements and those governed by MiFID. MiFID consists of a considerably more robust and comprehensive set of rules regarding firms' organisation, conduct of business and handling of conflicts of interest than can be found in UCITS.

These different standards raise questions as to the appropriate investor protection standards that should apply to collective portfolio management services, and the extent to which a level playing field should be sought in this regard between different financial services sectors. This also relates to whether a level playing field should be sought between different classes of UCITS management company -- some conduct business which falls under the scope of both UCITS and MiFID (e.g. where they conduct both collective and individual portfolio management services), whereas others may be subject solely to UCITS. To complicate this picture further, as noted there are significant variations in the requirements applying in different Member States -- some have extended MiFID requirements on investor protection and level playing field grounds to apply to UCITS, while others have not.

Such inconsistencies and unlevel playing field have emerged in a number of areas. For example:[99]

- Inconsistencies in the regulatory architecture governing the *marketing and selling* of UCITS -- UCITS management companies can market and sell their funds cross-border under the UCITS rules, without being subjected to MiFID sales and marketing rules which apply when MiFID investment firms distribute those same funds.

- As regards *best execution*, UCITS management companies are subject only to high-level conduct of business principles whereas MiFID provides for detailed rules on how instructions are to be executed.

- Also the UCITS requirements on *conflicts of interest* are lighter than those in MiFID. As a result the administrative requirements regarding management of conflicts of interest are more burdensome for MiFID authorised firms than for UCITS management companies (i.e. they have to deal not only with actual but also with potential conflicts of interest).

- Firms authorised under MiFID must organise compliance, risk management or internal audit functions in an *independent* manner. For UCITS, there are no detailed provisions of this kind, leading to variations at the national level.

Given these inconsistencies and their potential impact on levels of investor protection and market efficiency, it can be seen that applying standards developed by the level 2 measures to all management situations (national and cross-border) is essential; also, in regards level playing field issues, there is a strong presumption in favour of alignment with MiFID requirements.

ISSUE 1 Policy Options **Inconsistencies in and inappropriateness of organisation, conduct of business, conflicts of interest rules for management companies (Annex II.1)**
Baseline No action [not a viable alternative given the legal obligation for the Commission to adopt harmonising level 2 measures by July 2010]

[99] For a full overview of MiFID and UCITS interactions pleas refer to ECMI Policy Brief paper, April 2008,

Option 1.2: Minimal level of harmonisation

Under this scenario, the minimal level of harmonisation consistent with level 1 requirements would be adopted. Significant variations between requirements between Member States might remain, though a more detailed common framework would be applied.

Option 1.3: Great degree of harmonisation

Under this scenario, much greater degree of harmonisation in approach would be adopted; two sub-options emerge: whether for practical reasons the MiFID framework already adopted by a number of Member States would form the basis of this, or whether a wholly 'UCITS' model should be developed (potentially requiring those Member States that have already moved to MiFID approach to change their position.

ISSUE 1: Discussion of policy options

Baseline scenario is not a viable alternative given the legal obligation for the Commission to adopt level 2 measures by July 2010. Nonetheless, under the counterfactual it can be expected that inconsistencies in approach would continue to act as barriers to the efficient functioning of the UCITS market, and would raise investor protection issues.

Specifying and harmonising the operating conditions and rules of conduct of management companies is vital so as to ensure appropriate levels of investor protection and a level-playing field across the financial services sector, in addition to the impact of harmonisation on ensuring an effective passport mechanism in place. National measures alone will not be able to achieve this aim. This is the reason why the co-legislator has obliged the Commission to adopt level 2 measures by July 2010.

Both option 1.2 and 1.3 assume that the UCITS management company will be governed by additional set of rules with regard to requirements on its organisational structure, conflicts of interest and conduct of business, including organisational arrangements with respect to the risk management but they differ in the level of detailed or prescription.

Option 1.3 is most capable of delivering on the level 1 requirements and the outcomes being sought (level playing field, single market and, indirectly, investor protection), whilst minimising implementation/compliance costs where this gravitates to a MiFID framework that is already applicable to some UCITS and some activities undertaken by UCITS. Therefore the sub-option of option 1.3 that is being considered is the one, which seeks as much consistency as possible with the MiFID regime

Impact on Industry

Option 1.2 would imply lower compliance costs as firms would have more freedom to implement procedure and methodologies they deem appropriate. This would in effect do little to effectively get away with the identified differences in the way how the related requirements are being practices in the current environment. Finally, this option would in fact increase legal uncertainty as high level principles leave considerable room for manoeuvre for firms eventually increasing costs for firms who seek the maximum possible compliance with those principles.

The sub–option of option 1.3 can therefore be expected to benefit the UCITS fund industry most, given that management companies offering the investment services of individual portfolio management already need to comply with MiFID internal procedures and organisational requirements concerning conflicts of interest, and given that many Member States have already applied MiFID standards to UCITS firms when providing the core service of collective portfolio management.

Industry responses to the CESR consultation clearly support the approach proposed under the sub-option of option 1.3 (MiFID alignment), which is inclined to pursue MiFID alignment. Although no quantitative estimates could be provided by respondents, it is generally expected that no major additional costs should incur due to an alignment with MiFID requirements, given their respective national administrations have already introduced a regulation aligned (partially or fully) with MiFID requirements in this particular area. If any compliance costs as a result of sub-option 1.3, this will depend on whether and to what extent MiFID has already been applied to management companies at national level.[100]

Industry opinion with respect to proposals on **organisational issues in the risk management area is consistent with opinion relating to general organisational arrangements**. Responses to CESR's consultation with respect to this issue do not refer to MiFID compliance issues. This is largely due to the fact that when CESR was working towards establishing level 3 guidelines on risk management principles for UCITS, the relevant provisions of MiFID level 1 and level 2 were taken into account already at that time (in 2008) so as to ensure a level playing field. Overall, since the organisational requirements for management companies in the risk management area are broadly in line with the aforementioned guidelines, there was a broad consensus on the part of the industry with CESR's draft advice. Most respondents agreed with the content of the principles in this area, but nevertheless stressed the need to keep a principle-based approach with a minimal level of prescription, so as to ensure sufficient flexibility for management companies to be able to adapt to the actual risks incurred and to avoid unnecessary cost for managers. Most of the respondents also did not foresee any major additional costs from alignment with MiFID; some said that quantification was not possible and others pointed to the benefits that harmonisation might achieve.

Overall, the sub-option of option 1.3 (MiFID alignment) would minimise implementation and ongoing compliance costs for those UCITS management companies providing investment services (under MiFID) and would ensure a level playing field in this area for comparable activities – i.e. between individual and collective portfolio management.

Impact on supervisors

From the perspective of supervisors, option 1.2 would certainly impose lower costs on competent authorities that have already extended MiFID provisions to UCITS management companies engaged in collective portfolio management.

In this respect there are several Member States with near complete read-across of MiFID provisions on organisational requirements for the collective portfolio management of UCITS (for which the costs of sub-option of option 1.3 (MiFID alignment) would be none or minimal). There are however a few Member States with only a small extend of read-across, with regulatory practices of many Member States lying in between these boundaries. For these costs can be expected to vary according to the degree of change necessary.[101] Based on a preliminary work done by CESR in 2007 as regards mapping of this regulatory alignment we estimate that approximately 30% of asset managers, managing approximately 40% of UCITS assets operate in those Member State with little or no regulatory alignment with MiFID rules for UCITS. However these estimates may overstate the number of management companies impacted, since (1) robust data on group arrangements is

[100] Please refer to Table 6 in this section for an overview of areas that are proposed in the draft implementing Directive and that are based on or inspired by the MiFID implementing Directive.

[101] Refer to CESR's Final advice on content of level 2 measures in the area of Management Company Passport:

not available and (2) it is not possible to account for those management companies that do both MiFID as well as UCITS individual and collective portfolio management and decided to apply MiFID rules on a voluntary basis. It is also evident from replies of several industry associations to the CESR's consultation that a number of their members have voluntarily chosen to align internal compliance functions around MiFID standards.

Impact on Investors

Option 1.3 (MiFID alignment) appears also clearly to the advantage of investors. It is primarily in their interest to put in place such rules that are consistent as far as possible across the same entities that may offer different investment possibilities to them. What appears clear though, is the indirect impact that pursuing option 1.2 or 1.3 would have on investors. The advantage of adding more regulatory certainty by aligning requirements on UCITS managers with those of MiFID regulated firms as envisaged in option 1.3 would benefit investors in two ways: (i) it would give managers more time to engage in their core activity – the management of assets in the best interest of the investors and (ii) by reducing compliance costs of fund managers the investors should indirectly feel the benefits as well.

Cost impacts

There has been no concrete evidence in terms of quantifiable costs that would be provided from the respondents to the CESR's consultation as to the preferred option 1.3. The consultation however indicates proportionately lower impact of the option 1.3 in terms of costs as compared to the option 1.2 Overall, option 1.3 would minimise implementation/compliance costs for those UCITS management companies providing investment services (under MiFID) and would ensure level playing field in this area for comparable activities – i.e. individual/collective portfolio management. In this respect there are several Member States with near complete read-across of MiFID provisions on organisational requirements for the collective portfolio management of UCITS (for which the costs of option 1.3 would be none or minimal). There are few Member States with only a small extend of read-across, with regulatory practices of many Member States lying in between these boundaries – in the latter category the adjustment costs are therefore to be higher than in former group of Member State.

The costs linked with MiFID alignment could however be estimated using the preliminary mapping work done by CESR in the course of 2007 (not published) and the information from three particular studies.

--One-off costs--

The study done on costs compliance with selected FSAP measures[102] estimated among others also one-off costs and on-going costs linked to the introduction of MiFID rules, which included a split out of data for asset managers. Among the key cost drivers for one-off costs for asset managers the following areas were identified: *(1) client categorisation and amending client relationship management system, (2) making and storage of suitability assessment, (3) communication with clients, (4) refinement to best execution systems and associate IT investment, (5) development of revised policies on mapping conflicts of interest, (6) development of new training activities.* These cost drivers are identical to those identified in the cost-benefit analysis done by the Financial Services Authority (FSA) in the UK in 2006 on the impact of MiFID for UK businesses.

[102] See Annex I, section 3.2.3.

These key cost drivers do not appear a good proxy as such for the UCITS industry under the option here being analysed. For instance, UCITS do not need to deal with changes in client relationships in the way MiFID firms were obliged to. This is why client categorisation is not among the areas where implementing measures for UCITS would search for MiFID alignment.

On the other hand, UCITS management companies will be concerned – to a degree -- with best execution requirements, though there are reasons for thinking their costs will be lower than for MiFID firms. This is because the set up of a MiFID-compliant 'execution of orders' policy is more costly than the set up of a policy on 'placement of orders'. In the former case the management company would be executing orders directly in several execution venues and would therefore need to set up robust systems in order to ensure it is compliant with the requirements to obtain best possible results for the UCITS, it would need to have direct access to the execution venues, all of which would require additional cost. In cases where the management company decides to use other entities or intermediaries to execute the orders on their behalf, the main cost driver would only be linked to having a policy in place which ensure appropriate selection of the intermediary and follow up of how it fulfils the requirements to obtain best possible result for them. UCITS asset managers most often fall within the latter category and use intermediaries; therefore the related one-off costs would in most of the cases be linked to those related to placing of orders. It is actually already the case that majority of UCITS mangers use intermediaries to place their orders who are MiFID entities. In this respect the related costs would be negligible as the new requirements would only formally harmonise the business as usual practice of UCITS firms.

Furthermore, UCITS mangers will face costs in developing and reviewing their policies on conflicts of interest. However, given the more restricted scope of activities of UCITS management companies as compared to MiFID firms and related reduced scope of conflicts arising, the impact of related MiFID requirements is likely to be limited.

Under the FSAP study, one-off costs (adjusted so they match the relevant UCITS population impacted by these changes) stood at around EUR 1 billion. This figure is not however representative for the actual UCITS costs, for the reasons just mentioned – using the relevant breakdown for cost drivers, this allows for a rough estimate of about EUR 300 million. Indeed, this reduced figure is likely also to overstate costs for the following reasons: (1) the estimates may overstate the number of management companies impacted, since robust data on group arrangements is not available and (2) it is not possible to account for those management companies that do both MiFID as well as UCITS individual and collective portfolio management and decided to apply MiFID rules on a voluntary basis (or those that does this for their own reasons). The existence of such firms is evident from replies of several industry associations to the CESR's consultation whose members include companies from those Member States with little or no MiFID alignment. Given these factors, a further reduction in impact can be envisaged – possibly bringing the overall figure down to around EUR 150 million. These figures however must be interpreted with great caution.

--On-going costs--

Similarly, as regards the ongoing costs, the FSAP study refers to three key cost drivers that impact on asset managers: *(1) monitoring of best execution, pre-post trade transparency requirements, (2) data storage and (3) additional staff to conduct transaction reporting on an on-going basis.*

The only key cost driver that appears relevant to the proposed rules on UCITS is the one linked to the requirement of monitoring and reviewing policies established for best execution linked with placing of orders. The other areas in which costs can be expected are closely linked with new requirements on record keeping/storage of information, reporting and provision of information to investors (other than information that is covered by the provisions for KII), but the FSAP study did not identify such measures as key cost drivers for the industry.

When we take into account the costs estimated in the FSAP study related to on-going costs we can assume therefore – using similar reasoning as above in regards the one-off costs, that UCITS industry could be faced with costs ranging between EUR 250-80 million. However as stated above for the one-off costs, the same three factors need to be taken into account when considering the maximum possible impact on the industry. These costs

--Summary one-off and ongoing costs for issue 1--

A detailed screening of the proposed implementing legislation with respect to the reporting requirements and other requirements that could represent administrative cost/burden has been done and no particular requirements were identified that would have material impact.[103] In this respect the compliance costs identified for issue 1 are to be considered as purely compliance costs without any additional administrative burden.

-- cost for SMEs--

The cost impact on UCITS managers that are considered to be SMEs is to be limited. This is based on the conclusions of a study[104] that finds that the asset management *"industry is clearly dominated by companies that belong to a bank or insurance company. Since 2001 the average market share of these asset managers amounted to nearly 90% for the EU. Only in Ireland and the UK are relatively more independent asset managers specialists active (market share of the asset managers belonging to a financial institution was on average only 53% and 67% respectively)."* It is therefore expected that only 10% asset managers impacted by the changes would be of a small or medium-size.

However, for those most impacted by the changes, the driver of change is the level 1 requirement for more harmonisation, since those most impacted are in practice those working in jurisdictions that have taken a minimal approach to the implementation of conduct of business and other requirements on UCITS, and all steps consistent with the commitments undertaken at level 1 will create costs for these firms.

ISSUE 1: Conclusions

Overall, option 1.3 is most capable of delivering on the level 1 requirements and the outcomes being sought (level playing field, single market and, indirectly, investor protection), whilst minimising implementation/compliance costs by gravitating to the MiFID framework that is already applicable to some UCITS. (E.g. several Member States already have applied near complete read-across of MiFID provisions on organisational requirements for collective portfolio management of UCITS (for which the costs of option 1.3 would be none or minimal). Option 1.3 is therefore the preferred option; this is in line with the final advice provided to the Commission by CESR.

ISSUE 1 Summary of analysis

	Effectiveness	

[103] See Annex II, section 10

[104] See Annex I, section 3.2.2.

Policy Option	Level playing field	Investor protection	Remove barriers to EU fund integration	Efficiency
Baseline	0	0	0	0
Option 1.2: Minimal level of harmonisation	-	+	+	++
Option 1.3: Harmonisation on basis of MiFID	++	++	++	++

Magnitude of impact as compared with the baseline scenario: ++ strongly positive, + positive, -- strongly negative, - negative, = marginal/neutral,? uncertain, n.a. not applicable

Table 6: MiFID vs. UCITS Correlation table

Article of the draft directive (UCITS L2M)	**Number of box in CESR advice**	**MiFID level 2 Directive**	**Comments**
Chapter I – Subject-matter, scope and definitions			
Art. 1 - Subject-matter		-	-
Art. 2 - Scope		-	-
Art. 3 – Investment company	Box 8 of risk management section ('investment companies'), Page 57 point 9 – 'CESR considers that investment companies should not be treated differently from management companies'.	-	
Art. 4 - Definitions	Page 11, 61 and 100 of CESR advice	Art. 2 point 3 and 7:– definition of 'relevant person' and 'person with whom a relevant person has a family relationship'; Art. 11 – meaning of personal transactions; Art. 2 point 9 – definition of 'senior management' – as a	Certain definitions from the CESR advice were omitted in the text of the draft L2M as they are no more relevant for the text.

		basis	
Chapter II – Administrative procedures and control mechanisms			
Art. 5 – General requirements on procedures and organisation	Box 1 general organizational procedures and arrangements for management companies; points 1(a) – (c), (e), (f) and points 2 – 5; Box 3 of Section IV – risk management activities performed by third parties, points 1 and 3.	Art. 5 without para 1 (d) and (g)	Reproduced
Art. 6 - Resources	Box 1 general organizational procedures and arrangements for management companies, points 1(d) and (g); Box 3 of Section IV – risk management activities performed by third parties, point 2(c).	Art. 5 para (d) and (g) and second subparagraph of para 1	Reproduced
-	Box 3 - remuneration policy	-	Not reproduced – to be regulated at level 1
Art. 7 - Complaints handling	Box 6 - complaints handling	Art. 10	Reproduced with changes to point 3 (deletion the reference to the language but addition of the requirement that the complaints policy should be made available to investors free of charge – text from the explanatory text, point 43).
Art. 8 – Electronic data processing	Box 8 - part II 'Ability to process data electronically'	-	Reproduced
Art. 9 - Accounting principles	Box 9 - UCITS accounting principles	-	Reproduced
Art. 10 – Control by senior management and	Box 2 - responsibility of senior management, Box 10 (without point 4) –	Art. 9	Boxes 2 and 10 and point 2 of box 5 of Section IV were merged for the

supervisory function	implementation of the general investment policy, Box 5 (section IV) – Responsibility of the board of directors and internal reporting, point 2		reason of consistency. In para 2(a)(ii) it has been suggested that senior management should not be requested to approve investment strategies of each managed UCITS but to oversee the approval.
Art. 11 – Permanent compliance function	Box 4 - permanent compliance function	Art. 6 and Art. 9(2)	Reproduced
Art. 12 – Internal audit function	Box 5 without point 1(d) – internal audit	Art. 8	Reproduced
Art. 13 – Risk management function	Box 2 of section IV– risk management function, and Box 5 of section IV - point 5 - responsibility of the board of directors and internal reporting	Aligned with key principles laid down in art. 7(1) and (2)	Reproduced with drafting changes, new para 1 added.
Art. 14 – Internal reporting	Box 2 – Responsibility of senior management, points 2 and 3; Box 5 - of section IV - responsibility of the board of directors and internal reporting, point 4 and 5	Art. 9(2)	Reproduced
Art. 15 – Personal transactions	Box 7 – meaning of personal transactions and personal transactions	Art. 12	Reproduced but the first part of box 7 'meaning of personal transaction' was transferred to definitions. The definition of 'persons with whom a relevant person has a family relationship was merged into it.
Art. 16 – Recording of portfolio transactions	Box 8 – part I - 'Recordkeeping requirements', point 1	Art. 7 and 8 of MiFID L2 Regulation	Aligned with MiFID L2 Regulation with adjustments to the situation of UCITS
Art. 17 –	Box 8 – part III 'Recording	-	

Recording of subscription and redemption orders	of subscription and redemption orders'		
Art. 18 – Recordkeeping requirements	Box 8 – part 1 - Recordkeeping requirements, point 1 subpara 2-4 and points 2 and 3.	Art. 51 para 1 (without subpara2) and para 2 and 3	
Chapter III – Conflicts of interest			
Art. 19 – Criteria for the identification of conflicts of interest	Box 12 – Conflicts of interest potentially detrimental to a client of a management company or to an investor	Art. 21	Reproduced without point 3 as it refers to the direct distribution.
Art. 20 - Conflicts of interest policy	Box 13 – conflicts of interest policy	Art. 22(1) and (2)	Reproduced
Art. 21 – Independence of the conflicts management	Box 14 - independence of the conflicts management	Art. 22(3)	Reproduced without references to the direct distribution.
Art. 22 – Management of activities giving rise to detrimental conflict of interest	Box 15 – record of collective portfolio management or activities giving rise to detrimental conflict of interest, and Box 16 - management of non-neutralised conflicts	Art. 23; and Art. 18 of MiFID (in the latter case though the description of the situation is identical CESR suggests different approach than in MiFID.	Both boxes have been reproduced without references to the direct distribution. The difference in approach means that MiFID obliges to disclose to clients the nature and sources of conflicts of interest, CESR proposes that investors are informed ex post.
Art. 23 – Strategies for the exercise of voting rights	Box 11 – implementation of strategies for the exercise of voting rights	-	Reproduced
Chapter IV – Rules of conduct			
Art. 24 – Duty to act in the best interest of UCITS and their unit-	Box 1 – Duty to act in the best interest of UCITS and their unit-holders and to ensure market integrity	-	Reproduced without point 4 last sentence – the reference to churning was moved to the recital.

holders			
Art. 25 – Due diligence requirements	Box 2 – Due diligence requirements	-	Reproduced (points 1, 2 (partly) and 3)
-	Box 3 - Direct distribution	-	Was not reproduced as it will be reflected in the work on PRIPs
-	Box 4 – Appropriateness test and execution only	Art. 37	Was not reproduced as it will be reflected in the work on PRIPs
Art. 26 Handling of subscription and redemption orders	Box 5 - Handling of subscription and redemption orders of investors	-	Reproduced
Art. 27 – Reporting obligations in respect of execution of subscription and redemption orders	Box 6 – Reporting obligations in respect of execution of subscription and redemption orders	Art. 40 aligned to the situation of UCITS	Reproduced
Art. 28 – Execution of decisions to deal on behalf of the managed UCITS	Box 7 – Duties of management companies to act in the best interests of the UCITS when executing the decisions to deal on behalf of the managed UCITS in the context of the management of their portfolios	Art. 44(1) as a basis	Reproduced
Art. 29 – Placing orders to deal on behalf of UCITS with other entities for execution	Box 8 - Duties of management companies in the context of the management of UCITS portfolios to act in the best interests of the UCITS when placing orders to deal on behalf of the UCITS with other entities for execution	Art. 45 as a basis	Reproduced
Art. 30 – General principles	Box 9 – General principles	Art. 47	Reproduced
Art. 31 –	Box 10 - Aggregation and	Art. 48 and 49 as a	Reproduced

Aggregation and allocation of trading orders	allocation of trading orders	basis	
Art. 32 – Safeguarding the best interests of UCITS	Box 11 - Inducements	Art. 26	Point 1 and 3 of box 11
Chapter V - particulars of the standard agreement between a depositary and a management company			
-	Box 1	-	No need to reproduce
Art. 33 – Content of the agreement	Box 2 and box 3	-	Reproduced
Art. 34 – Electronic transmission of information	Box 2, 4th subparagraph	-	Reproduced
Art. 3	Box 4	-	Reproduced
Chapter VI – Risk management			
Art. 35 – risk management policy	Box 1 - Identification of risk and risk management policy, Box 5 - Responsibility of the board of directors and internal reporting, point 6	Aligned with principles laid down in Art. 7(1)	Reproduced with following clarifications: - the meaning of material risk was introduced, - elements to be contained in risk management policy listed in para 2 are not exhaustive.
Art. 36 – Assessment, monitoring and review of risk management policy	Box 5 point 1 – responsibility of the board of directors and internal reporting	Aligned with principles laid down in Art. 9	Reproduced
Art. 37 – Due diligence in implementing risk management policy	Box 2 of Section II - Due diligence requirements , points 2 and 4; Box 3 – Risk management activities performed by third parties, point 2 (s)	-	Reproduced

	and (b).		
Art. 38 - Measurement and management of risk	Box 4 - Risk measurement and management	-	Reproduced
Art. 39 – Calculation of global exposure	Box 9 – Global exposure	-	Partly reproduced, new text has been added. Reference to CESR was reflected in the recital.
Art. 40 – Commitment approach	Box 10 – Commitment approach	-	Reproduced. Reference to CESR was reflected in the recital.
Art. 41 – Counterparty risk and issuer concentration	Box 12 – Counterparty risk/issuer concentration	-	Reproduced. Reference to CESR was reflected in the recital.
Art. 42 - Procedures for the assessment of the value of over-the – counter (OTC) derivatives	Box 6 – Procedures for the valuation of over-the – counter (OTC) derivatives	-	Reproduced
Art. 43 – Reports on the derivative instruments	-	-	
-	Box 7 – Supervision	-	Not reproduced as it extends level 1 implementing powers
-	Box 11 – Value at risk and advanced risk measurement methodologies	-	Reflected in the recital
Chapter VII			
Art. 44 - Transposition	-	-	
Art. 45 – Entry into force	-	-	
Art. 46 - Addressees	-	-	

7.3. Background to the problem of ISSUE 2: Rules on risk management and measurement for UCITS management companies

Risk management is a core activity in relation to funds. Funds take on exposure to risk so as to create returns to the benefit of investors, and have therefore to manage that exposure in keeping with the investment objectives and policy of the fund. Recent market turbulence has underlined once again the need for comprehensive and effective risk management at all levels in the financial services.

The UCITS Directive only contains a set of high-level principles on risk management. This reliance on high-level principles has meant that there has been no substantive consistency in detailed requirements at the national level as regards risk management procedures and processes, leading to a fragmented approach to risk management and measurement requirements. This fragmentation raises the risk of significant regulatory gaps and weaknesses and may provoke regulatory arbitrage.[105]

Problems related to the identification of risk by UCITS management companies, and the measurement and management of these risks had already been outlined by means of a mapping exercise by CESR in the course of 2007, which illuminated a number of inconsistencies and divergent approaches to the same or similar issues across Member States.

With the introduction of the management company passport in UCITS IV and based on the experience from the financial crisis it has become vital to reduce inconsistencies in cross-border risk management in so far as this will provide greater assurance for domestic and cross-border investors and counterparties as to the effectiveness and dependability of the UCITS framework. Any steps to reduce inconsistencies between national regimes will also offer opportunities for regulatory arbitrage. In light of this, UCITS IV provided new implementing powers to the Commission in this area, so that level 2 measures can be developed to establish a uniform and consistent approach to the UCITS risk management processes.

Analysis of the risk management of UCITS can be broken down into three distinct areas.

7.3.1. Governance and organisation of the risk management process of UCITS management companies

The fundamental requirements for sound risk management systems consist in organisational, governance and other specific safeguards and due diligence requirements placed on UCITS management companies in order to ensure they possess the capacity for effective and comprehensive identification, measurement and management of risks.

- As regards the content of governance and organisation of the risk management process of UCITS management companies, the following broad (interlinked) issues are relevant:

  (i) definition of roles and responsibilities, including for the board of directors and relating to internal reporting;

[105] For a comprehensive description of UCITS risks stemming from the extended investment powers granted to UCITS in 2001 amendments and for an overview of the level of harmonisation in this area prior to adoption of UCITS IV please refer to Background Chapter of this section and also to Annex I, section 3.2.1.

(ii) operational requirements relating to the risk management function; and

(iii) safeguards in case of risk management activities are performed by third parties.

These organisational and conduct of business arrangements are a subset of the wider organisational issues addressed already above under ISSUE 1. The same mechanisms discussed in relation to ISSUE 1 apply in this context (e.g. in regards the impact of inconsistencies), and the same solutions (e.g. the value of coordinating UCITS organisational requirements with those applying in MiFID so far as this is possible). Given these similarities, the specific case of organisational requirements relating to the risk management process will not be considered discretely in the risk management section of this impact assessment. However it is appropriate to indicate what divergences have been notified in this particular area (see box 7.1 below).

- **Box 7.1: Member States' regulatory practices with respect to governance and organisation of the risk management process of UCITS management companies**

- There is no harmonisation in the regulatory practices on risk management measures. Only about half of the Member States’ authorities perform ex-ante supervision of risk management policy and procedures of the management company at the time of its authorisation (although most of them do it on on-going basis).
- The vast majority of Member States provide in their legislations that units in charge of risk management and asset management must be functionally segregated and operate independently but there are few Member States with not specific requirements at all.
- Most Member States allow for risk management to be delegated to a third party (although subject to different conditions across these Member States) though there are few Member States that do not allow for delegation at all.
- The strong majority of Member States provide for separation/independence between risk management and asset management units, but few Member States have no specific requirements at all in their national legislation.

7.3.2. Coverage of risks by risk management policy

UCITS are subject to financial risks and to certain operational risks that can lead to potential losses for investors. A distinction needs to be drawn between expected or anticipated risk exposure – which is intrinsic to the capacity for a UCITS to deliver investment returns above the risk free rate – and the unexpected or unanticipated crystallisation of risks, for instance where a UCITS is exposed to types of risk that were not expected in an uncontrolled manner.

Prior to 2001 most of the relevant risks investors were exposed to were related to the fluctuation of the market value of the securities invested by the UCITS – **market risk**. With the increased investment powers of UCITS and the possibility to invest in derivatives and other more complex products new risk factors emerged such as **credit risk, counterparty risk** and **liquidity risk**. These risks represent the possible impact of events which may impair the trading conditions of certain securities (illiquidity) or the credit rating of specific issuers (default) or counterparties of bilateral transactions (insolvency). As regards **operational risks**, these are attached to the different features and quality of the trading, settlement and valuation procedures operated by the management company.

The risk management processes for UCITS must already have a sufficiently wide scope so as to encompass all relevant risks, so that the identification element of risk management is not artificially delimited: the Commission Recommendation 2004/383/EC on the use of derivatives by UCITS already established that all risks relevant to UCITS should be within the scope of its risk management policy. This approach was further confirmed in the Guidelines on Risk Management Policy for UCITS issued by CESR in February 2009 and subsequently in CESR's final advice submitted to the Commission in September 2009.

7.3.3. Principles for risk measurement and management

While there has been broad industry support for an all-risk-encompassing scope, the fundamental issue facing risk management requirements has been related to the extent of harmonisation that can be achieved with regards to the detailed requirements on risk identification, measurement and management; an overly prescriptive approach runs the significant risk of building regulatory failures into the management process, e.g. where a prescribed methodology is insufficiently effective or has its own distortions; yet an approach which is too high-level runs the risk of fragmenting and weakening the overall UCITS market, leading to regulatory gaps and arbitrage, and consequent investor protection issues.

The fundamental issue therefore relates to the content of the risk management processes that a UCITS should follow. Such content does not need to be built from scratch: notably, it can be developed on the basis of the level 3 Guidelines on Risk Management principles for UCITS as adopted by CESR in February 2009. Where organisational measures are designed to ensure that the risk management function is well equipped to undertake its work, measures on risk management principles are designed to create greater consistency in the approaches adopted by different management companies. The underlying issues in this area are similar to those identified above: fragmentation in approach between different Member States, barriers to cross-border trade (particularly in the context of the MCP), leading to an uneven playing field and investor protection concerns. There are three particular areas in which specific principles are found in the UCITS framework:

(i) Principles governing methodologies to be used for the calculation of the global exposure

(ii) Principles governing calculation of counterparty risk exposure stemming from OTC derivatives

(iii) Procedure for valuation of over-the-counter (OTC) derivatives

Just as with the first issue, inconsistent approaches have emerged between Member States as regards the content of detailed requirements on risk identification, measurement and management.[106] This has become a more important issue following UCITS III changes, which extended the range of eligible investments and investment strategies available to UCITS. Following these changes, UCITS risk management became increasingly complex for those UCITS that made use of the new investment possibilities, requiring increasingly sophisticated risk management processes.

[106] Note that the risk management processes for UCITS must already have a sufficiently wide scope so as to encompass all relevant risks, so that the identification element of risk management is not artificially delimited: the Commission Recommendation 2004/383/EC on the use of derivatives by UCITS http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004H0383R(01):EN:NOT) already established that all risks relevant to UCITS should be within the scope of its risk management policy. This approach was further confirmed in the Guidelines on Risk Management Policy for UCITS issued by CESR in February 2009 and subsequently in CESR's final advice submitted to the Commission in September 2009.

Refinements to the UCITS framework and to Member States requirements on risk management, notably Commission Recommendation 2004/383/EC, have attempted to address these developments by encouraging a general raising of standards and requirements across the UCITS industry. However, work undertaken by CESR during 2007 (see box 7.2 and 7.3) indicated a lack of harmonization in Member States' regulatory practices on risk management measures and indeed a high level of divergence regarding implementation of related provisions of the UCITS Directive and the Commission Recommendation 2004/383/EC.[107] Similar findings were revealed also by an external study conducted in selected Member States in the course of 2007-2008.

To be more concrete, the key areas of divergence that have been identified relate in large part to technical matters relating to risk identification and measurement methodologies.

(i) *Global exposure*

The article 51(3) of the UCITS Directive places a cap on 'global exposure' (i.e. extent to which the UCITS is impacted by movements in underlying asset values). While the assessment of such global exposure is relatively simple for straight equity funds, the accurate assessment of such exposure can be more complicated for other funds. While Commission Recommendation 2004/383/EC outlined two broad methodologies (a so-called 'commitment approach' and an alternative methodology based on the calculation of Value-at-Risk (VaR) figures), the recent study[108] and survey noted above indicate that significant variations at the national level (see box 7.2), including as to the degree of prescription.

Box 7.2: Member States' regulatory practices with respect to understanding of global exposure limits and requirements on their management and measurement

There is a high level of divergence regarding the implementation of the limit stipulated in the UCITS Directive (article 51(3)). For instance, **over one third of Member States** require exposures arising from derivatives to be included l others do not. **Less than half of the Member States** adapt risk measurement methodologies to the risk-profile of a UCITS –the 'Commitment' approach, Value at Risk (VAR) or other sophisticated methodologies are allowed to varying degrees, and MS differ widely as to the parameters they require to be used within these methodologies. **Half of the Member States** require stress testing to help manage risks related to abnormal market movements, while some MS require a back testing of the risk measurement model against historic circumstances.

(ii) Counterparty risk exposure

Article 52(1) of the UCITS Directive places limits on exposure to counterparties by means of OTC instruments, so as to limit the counterparty risk faced by UCITS. However, the technical application of these limits and related possibilities for 'netting' of exposures, raises a number of questions of interpretation and, as with the measurement of global exposure, differences have emerged between the approaches adopted in Member States (see box 7.3).

Box 7.3: Member States' regulatory practices with respect to requirements on counterparty risk management and measurement

[107] Refer to previous footnote for the link to the Commission's Recommendation.

[108] Study on "investment funds in the European Union: comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets", http://ec.europa.eu/internal_market/investment/other_docs/index_en.htm#studies, see in particular section 6.1

There is no uniformity with regard to the calculation of counterparty risk including rules relating to netting of derivative positions or the use of collateral. Half of the Member States do not allow for variations in the amount of counterparty risk depending on the nature of the counterparty, while others allow variations within the limits set by the level 1 provisions.

Only Luxembourg, Germany and Ireland allow (under certain conditions) for the netting of counterparty risk on financial derivative instruments with the same counterparty.

(iii) *Valuation of OTC derivatives*

Differences have also emerged as to how OTC derivatives[109] should be valued (largely since such valuations typically require modelling that itself entails necessary approximations and assumptions to be made). A recent study[110] has shown that a principle on such valuations in the UCITS Directive -- valuation should be subject to reliable and verifiable valuation on a daily basis – has been transposed and interpreted very differently in Member States under review – Luxembourg, Ireland, Germany, the United Kingdom and Spain

These issues are technical, relating to the particular risk measurement and assessment techniques necessary for dealing with particular investment strategies and the features of particular financial instruments, and for ensuring certain requirements in the UCITS framework in regards limits on risk exposures and the use of derivative instruments.

While it is clear that inconsistencies in approaches to risk measurement and management lead to investor detriment, level playing field and regulatory arbitrage issues, as noted the complete harmonisation of these on the basis of an exhaustive common rulebook would run the significant risk of regulatory failure. The focus of the analysis in relation to the principles of risk management and measurement is therefore on assessing the degree to which it is necessary or even possible to set all the specific parameters of these methodologies through level 2 implementing legislation, or whether a mixture of implementing measures and level 3 guidelines or other means is more appropriate (and if so, what the precise content of this mixture should be). The issue to address in considering options is ensuring investor protection and financial stability goals are met in a context where there is ongoing technical development and where innovation (new strategies and instruments) may generate risks that are not adequately captured by pre-existing methodologies.

ISSUE 2 Policy Options

Inconsistencies in and inappropriateness of risk management (Annex II.2)

Baseline No action [not a viable alternative given the legal obligation for the Commission to adopt harmonising level 2 measures by July 2010]

Under this scenario, there would be no level 2 measures and the status quo would prevail, i.e. high level principles of risk management at level 1, complemented by the Commission Recommendation 2004/383.

[109] The future legislative framework governing OTC derivatives being currently and separately considered by the Commission should have a positive impact on the various risks UCITS funds are exposed to with respect to the OTC derivative. The issues that are linked to OTC derivatives within the work on level 2 measures for UCITS would however not be subjected to significant changes in the light of the proposed potential measures and their objectives outlined in the latest Commission Communication on OTC derivatives. Also see Annex I for more details on Commission's work on the future legislative measures with respect to the OTC Derivatives

[110] Study on "investment funds in the European Union: comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets", http://ec.europa.eu/internal_market/investment/other_docs/index_en.htm#studies, see in particular section 6.1.8

Option 2.2: **General/high level principles of risk management**

This option would be limited to further developing general/high level principles to be observed by management companies within the risk management process without any detailed harmonisation of the procedural steps to be observed when dealing with specific risks as identified by the risk management function. Member States may require more detailed steps.

Option 2.3: More detailed/prescriptive principles of risk management and measurement techniques at level 2

Under this option, specific principles of risk management and measurement techniques would be set out and harmonised at level 2, effectively moving certain elements (but not all) of the Commission Recommendation 2004/383/EC to a binding level, but leaving more flexibility for member states over detailed technical approaches.

With respect to market risk, limits of **global exposure** as well as measurement techniques to be used for its calculation (e.g. the use of Commitment approach, Value at Risk (VAR) approach as well as other more sophisticated methodologies) specific principles would be provided for at level 2. The detailed parameters of the underlying methodologies would be specified by CESR in the level 3 Guidelines (in the future potentially technical standards proposed by the new authority ESMA).

Similarly, with respect to **counterparty risk**, the principles of how to calculate exposure to counterparty risk in particular arising from the use of OTC derivatives would be set out at level 2. The details of how some of these principles or approaches should be implemented or used would then be further specified by CESR in the level 3 Guidelines (in the future potentially standards proposed by the new authority ESMA.

As regards procedures for **valuation of OTC derivatives**, addressing particularly valuation risk (operational), this option would entail that level 2 would set out specific principles of what needs to be done by the management company in order to ensure that assessment/valuation of OTC derivatives is accurate and independent. There would be no prescription of the specific models and valuation techniques to be used at level 2. These would however need to be subject to certain standards that are in line with the principles of risk management and measurement

Option 2.4: **More detailed/prescriptive principles of risk management and measurement techniques at level 2 complemented by harmonisation provisions for risk measurement techniques**

This option would build on option 2 but add details of the inherent parameters of underlying methodologies at level 2 rather than through guidance or technical standards. To the extent that ESMA did not adopt technical standards in this area under option 2.3, this would represent a maximal degree of harmonisation of approaches across EU.

ISSUE 2: Discussion of policy options

Specifying and harmonising the risk measurement and management rules for management companies is vital to ensure appropriate investor protection, a level-playing field across the financial services sector as well as to ensure the passport mechanism functions effectively. National measures alone will not be able to achieve this aim. This is the reason why the co-legislator has obliged the Commission to adopt level 2 measures by July 2010. Therefore, the baseline scenario is not viable alternative but will be used further in the discussion. Therefore, the discussion of options here will focus on the potential content of the level 2 measures so mandated.

Option 2.2 would set out only high-level standards or principles for the risk management process, without any further details as to the procedural steps to be observed with respect to individual risks being faced by the management company. Both option 2.3 and 2.4 assume that the UCITS management company will be governed by a more detailed and prescriptive set of rules with regard to risk measurement and management; the difference between these options lies in the decision as to whether level 2 measures should contain the detailed parameters of the methodologies used when dealing with the various risks identified by the risk management policy of the UCITS management company.

Impact on Industry

Option 2.2 would in many instances be a step back from some of the practices observed by a number of UCITS management companies already (see the Background section below for more detail) but overall industry would be exposed to lower compliance costs as firms would have higher degree of freedom to implement procedures and methodologies they deem appropriate. However, this would increase the gap as to the comparability of methodologies and risk management processes being applied by similar fund types in different Member States. Also, reduced legal certainty in relation to a more principles based approach may increase some costs for firms as they seek to ensure their approach is appropriate.

Leaving the detailed parameters of methodologies or specifications of criteria against which certain principles can be applied out of the scope of legislation is however viewed by the industry as appropriate. While the harmonisation of such parameters would achieve the objective of providing a level playing field between managers to its highest possible extent, as in option 2.4, this would however not be an efficient solution. The sustainability and the appropriateness of details in a legislative text may be severely constrained, with requirements becoming obsolete and an obstacle to effective risk management as new and better techniques, financial instruments or investment strategies emerge. From the perspective of industry, leaving the detail of methodologies and their parameters to be tackled by CESR in level 3 guidelines is the preferred option.

Impact on supervisors

Option 2.2 would leave the most discretionary powers to supervisors as compared to option 2.3 and 2.4 respectively. The high level of discretion goes along with the need to establish appropriate processes and arrangements to deal with the lack of detail associated with the relatively high-level and general principles that would be enshrined at level 2. The higher the level of discretion the more judgement the regulatory authorities need to exercise with respect to the various issues that would be required by the level 2 measures. Pursuing option 2 would most likely not ensure the level playing field objective, i.e. the maximum possible uniform application of the risk management and measurement principles across Member States. In addition, option 2.2 would most likely be more resource intensive than potentially option 2.3 and 2.4. Although all of these options (2.2-2.3-2.4) would entail costs and would necessitate adequately knowledgeable personnel, option 2.2 appears to be most resource intensive as each regulatory authority would need to go beyond the high-level principles and develop more detailed criteria and processes in order to achieve the certainty they would deem as appropriate. This would have unequal impact in terms of costs for different authorities and would go against the objective of ensuring level playing field. Yet a high degree of regulatory alignment is an essential pre-condition for ensuring trust can be built up between regulators, so as to facilitate the efficient functioning of the management company passport and the UCITS single market more generally.

When comparing between options 2.3 and 2.4 it appears that the latter provides for the highest certainty on the part of supervisory authorities and supports the level playing field objective to the greatest extent, as there would be full certainty established at level 2 with very minimal or no level for manoeuvre by the authorities as to how to implement such measure in practice.

However, experience shows that as specification of certain details at level 3 (via level 3 guidelines). For instance, peer reviews of the application of guidelines place considerable pressure on national supervisors to explain non-adherence where this occurs. Level 3 guidelines represent in a first place a compromise approach that is based on thorough assessment of various practices and experiences of Member States on the ground and so will generally be practical and applicable for all Member States.

Impact on investors

From the perspective of investors, under option 2.2 national authorities would have a high degree of discretion with respect to the implementation of an appropriate framework for oversight of management companies' risk management and measurement processes and procedures, so investments in comparable funds (with respect to the associated risks or investment strategy) in different Member States would indirectly expose them to diverging level of regulatory standards. Potentially they could face indirectly the associated costs in those Member States who would adopt more detailed and prescriptive approach to their management companies compared to other Member States. Regulatory arbitrage could also have the effect of reducing effective competition in the UCITS market.

As to the option 2.3 or 2.4, the same argumentation applies as when comparing these options from the perspective of regulatory authorities, though the reduced responsiveness of standards enshrined at level 2 to innovation and developments in the markets may have the effect of rendering option 2.3 less effective in the longer run in ensuring adequate investor protections standards are in place. The adequate and robust standards should therefore be best achieved via option 2.3.

Compliance costs

More detailed prescription of risk management procedures that would need to be applied by management companies appears to be acceptable to the industry according to the results of the CESR consultation, which is corresponding to option 2.3. Compliance costs will arise but they will vary depending on what types of risk identification, management and measurement mechanisms UCITS managers have in place; these might be limited for some since a number of countries (see again background) do have similar requirements in place already (i.e. a varied alignment with the principles embedded in the Commission Recommendation has already taken place). Detailed technical requirements – for instance, to apply back-testing, stress-testing or scenario analyses where appropriate -- might lead system changes in particular investing into/setting up more sophisticated IT systems which in turn will then require additional/highly qualified staff. This level of prescription is however deemed necessary in order to give managers a minimum requirements/criteria around which their risk management systems will be established and maintained.

The adjustments expected to occur as a result of implementing option 2.3 can be considered to be similar to those expected in regards the preferred option for issue 1 (option 1.3) since both of the preferred solutions follow a more detailed principles based approach for the harmonisation via level 2 measures. The estimated cost impact as presented for the preferred option under issue 1 can in this regard be taken as a proxy since replies to the CESR consultation did not provide any estimates. However, the compliance costs can not be expected to be in the same proportion as for the issue 1. The main reasons is the fact that unlike for issue 1, the Commission issued Recommendation in which it intended to harmonise number of the aspects that are now subject to implementing legislation and CESR mapping in this regard provides for enough evidence that although not full a considerable level of compliance on the part of management companies has already taken place. As such, it could be estimated that one-off costs and ongoing costs related to the adjustments in companies' risk management structures could be one fourth of those estimated for issues 1 i.e. one- off costs in the range of EUR 75-35 million and between EUR 60-20 million for on-going costs.[111]

--Summary one-off and ongoing costs for issue 2--

As with issue 1, a detailed screening of the proposed implementing legislation with respect to the reporting requirements and other requirements that could represent administrative costs/burden has been done and although one requirement has been identified as imposing administrative burden on companies, its estimated financial impact of EUR 240 thousand for the industry as a whole is not considered as significant or material and also the obligation required by the relevant provision of the implementing article has in fact already been established in the level 1 Directive, article 51(1).[112] In this respect the compliance costs identified for issue 1 are to be considered as purely compliance costs without any additional administrative burden.

-- Cosst for SMEs--

As with issue 1, also for the related adjustments with respect to risk management and measurement requirements to be proposed via the implementing legislation should not have material impacts since the driver of change is the level 1 requirement for more harmonisation.

Table 7.1: Examples of the possible divide between level 2 and level 3 (option 2.3):

Global exposure	**Level 2**		**Level 3**
	Global exposure of a UCITS to be calculated as: (i) the incremental exposure and leverage generated by the managed UCITS through the use of financial derivative instruments including embedded derivatives, which may not exceed the total of the UCITS NAV or (ii) the market risk of the UCITS portfolio	→	Level 3 guidelines to be developed on the limits used to calculate VAR including the maximum permitted VAR, the minimum observation period used and the use of stress testing and back testing.
	Allowable methodologies to calculate global exposure are: commitment approach, value at risk (VAR) or other advanced methodologies		
	MC should conduct, stress test, back tests and scenario analysis where appropriate to ensure adequate and effective processes to measure and manage at any time the risks of the UCITS and to ensure compliance with limits concerning global exposure		
	When MC use commitment approach they should convert the financial derivatives positions into the market value of an equivalent position in the underlying asset of that derivative	→	Level 3 guidelines with respect to the conversion method to be used for specific types of financial

[111] It should be noted that the same caveats apply also for option 2.3 as for the cost estimation of option 1.3 for issue 1.

[112] See Annex II, section 10

			derivative instruments
	--these MC may benefit from the effects of netting and hedging arrangements to reduce their global exposure subject to certain criteria	→	Level 3 guidelines on the criteria to be used in assessing whether netting or hedging arrangements may be used to reduce global exposure using the commitment approach
Counterparty Risk	Counterparty risk exposure (CRE) arising from OTC derivatives to be calculated using the positive mark to market value of the OTC derivative contracts	→	-
	When calculating CRE UCITS may net derivative positions with the same CR	→	Level 3 guidelines with respect to limits to be applied in relation to techniques and instruments (other than financial derivative instruments) including repurchase transactions or securities lending transactions.
	UCITS may reduce CRE through receipt of collateral, but it has to comply with certain principles.	→	Level 3 guidelines with respect to the principles the collateral shall comply with in order to be acceptable for a reduction of CRE.
Valuation of OTC derivatives	MC shall not rely only on market quotations for the purpose of assigning fair values regarding exposures to OTC derivatives, fair valuation of exposures to OTC derivatives to be independently assessed, arrangements for assessment of fair value to be proportionate to the complexity of OTC derivatives concerned.	→	-

ISSUE 2: Conclusions

Baseline scenario is not a viable alternative given the legal obligation for the Commission to adopt level 2 measures by July 2010. To se the principles at general level (option 2.2) would not ensure uniform application of the rules across the EU and such an uneven application could potentially result in different levels of investor protection, a situation that would not be very different from the baseline scenario. Option 2.4 when compared to option 2.3 would not have major cost impact from supervisors' perspective (though could require some supervisors to significantly change their approach) but may prove to be impractical and non-flexible for the industry, which could impact on costs for investors. Option 2.4 could also lead to less effective techniques being adopted, raising systemic risks; it may be less responsive than option 2.3 to the development of improved approaches and the tailoring of these to new investment strategies.

Option 2.3 will entail adjustment costs on the part of management companies as well as supervisors, but these would be tempered by the retention of some flexibility. Respondents to CESR consultation did not provide concrete evidence in terms of quantifiable costs as to the option 2.3. However, more detailed prescription of risk management procedures that would need to be applied by management companies appears to be acceptable to the industry, which is corresponding to option 2.3. Compliance costs will arise but they will vary depending on what types of risk identification, management and measurement mechanisms UCITS managers have in place already and existing evidence suggests that partial alignment with principles embedded in the Commission Recommendation already took place at Member States' level although to a different degree.

Option 2.3 is therefore the preferred option that is in line with the final advice provided to the Commission by CESR.

ISSUE 2 Summary of analysis

Policy Options	Effectiveness			Cost Efficiency
	Level playing field	Investor protection	Remove barriers to EU fund integration	
Baseline	0	0	0	0
Option 2.2: General/high level principles of risk management	-	-	-	--
Option 2.3: More detailed/prescriptive principles of risk management and measurement techniques at level 2	++	++	++	+
Option 2.4: More detailed/prescriptive principles of risk management and measurement techniques at level 2 complemented by harmonisation provisions for risk measurement techniques	+	+	-	-

Magnitude of impact as compared with the baseline scenario: ++ strongly positive, + positive, -- strongly negative, - negative, = marginal/neutral,? uncertain, n.a. not applicable

Background on investment powers of UCITS and related risks

The original UCITS Directive (611/85/EC) embodied a very conservative investment focus. It essentially restricted fund managers to plain vanilla bond and equity investment strategies. Even money market funds were excluded. These severe restrictions on the universe of admissible investment policies risked undermining the commercial relevance of the UCITS framework. In 2001, significant adjustments to, inter alia, investment powers available to UCITS funds were introduced at level 1 (the so called UCITS III). The most significant changes are included box 7.4. Consequently, in 2007 the European Commission has further clarified definitions of certain instruments eligible for UCITS portfolio in the implementing directive on UCITS' eligible assets.

Box 7.4: Investment powers available to UCITS since 2001

The possibility for UCITS to invest in money market instruments

Possibility for index-based funds including (listed) Exchange Traded Funds

Fund of fund investment policies whereby fund manager constitutes a portfolio comprising investments in other funds. This strategy is thought to offer potential for creation of diversified basket of top-performing funds. Main drawback is the high level of cost embedded in the structure (fees generated at fund of fund level and at level of underlying fund).

Possibility for funds to invest in financial derivatives to amplify expected returns (options, swaps, futures). Derivatives based leverage was subject to an overall cap (exposure through derivatives instruments should not exceed the market value of assets held by the fund.

Possibility for funds to invest in exchange traded and OTC financial derivatives (subject to counterparty risk management procedures).

Since then, we have seen that UCITS fund managers have moved swiftly to make extensive use of these enlarged investment powers and techniques. Recent research[113] shows an increased use of derivatives. The respondents to the study estimate that the use of OTC derivatives has grown at a rate 10% per annum since the implementation of UCITS III. It should be noted that investment in derivatives remains limited – and is generally motivated by hedging rather than leveraging purposes. However, there is a growing number (statistics) of UCITS funds which use derivatives more extensively to generate leverage or protect capital.

Investing in derivatives also allows UCITS to gain exposure to some asset classes that would not be eligible as direct investment. For example, UCITS are prohibited from holding loans or debt as an asset in the portfolio. However, through investment in credit derivatives, UCITS can gain exposure to credit risk in a more transferable form.

Some examples of the new types of investment strategy are briefly introduced below. It is important to emphasise that these investment strategies are only now being brought to market, and that they represent a small part of the UCITS universe.[114]

Box 7.5: More sophisticated investment strategies available to UCITS

Absolute return: An absolute return strategy seeks to achieve positive returns in both up and down markets. This is in contrast with a relative return strategy, which measures a fund manager's performance against a market benchmark or index.

Capital protection/structured funds: use of options to limit potential for losses;

130/30: This is one of the hedge-fund type strategies, which includes 30% synthetic long and short positions via OTC-derivatives such as contracts-for-difference or total return swaps, synthetic short positions are used (within limits of overall global exposures) to leverage performance on expected strongly performing assets while profiting from expected future declines in values of absolute return strategies.

Global tactical asset allocation (GTTA): GTAA is a strategy that directs funds toward asset classes with the highest potential for appreciation and away from asset classes with greater potential for loss. Such strategy targets all sorts of alternative asset classes including emerging market debt, global bonds, commodities, and international equities.

The increased range of investment styles – offering different combinations of return enhancement or risk mitigation – is potentially attractive to investors. For the present, these investment styles are still largely unproven in terms of performance.

Increased use of financial derivatives and other techniques to increase exposure to new asset classes have also transformed the risks embedded in investment funds. The main source of risk incurred by investors in traditional long-only funds was market risk. This could prove to be significant as investors

[113] Study on "investment funds in the European Union: comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets", http://ec.europa.eu/internal_market/investment/other_docs/index_en.htm#studies

[114] Ibid

in equity funds discovered to their cost in the aftermath of the dot-com bubble. Operational/administration risk (failed trades, valuation errors) was another source of risk. However, the sources of risk were few and relatively well-understood (if not foreseeable).

The mix of risks in fund management/administration has been altered by the new investment powers used by UCITS managers **since 2001**: some risks have become more acute and some **new sources of risk have been added**. Conversely, new investment powers provide additional risk-mitigation tools.

Box 7.6: Main risks associated with more sophisticated investment fund strategies:

Market risk: is risk linked to the exposure to fluctuation of market value of the security

Leverage: use of leverage may amplify the market risk associated with any given position.

Credit risk/counterparty risk: is risk due to uncertainty in a counterparty's ability to meet its obligations

Liquidity risk: arises from the difficulty of selling an asset.

Settlement risk: when incurring obligation to deliver an asset at a future date, fund may encounter difficulties in sourcing that asset when needed.

Operational risk: New eligible instruments may be more challenging in terms of operational risk controls (for purposes of valuations, margining, collateral management)

Enlargement of investment powers was necessary to keep pace with the profound changes in European securities, credit and derivatives markets. They also have the potential to improve outcomes for investors. However, this clearly entails a broader set of risk management challenges for fund managers and supervisors, not least since convergence between alternative investments[115] and UCITS making use of the new powers has been acknowledged by many asset managers.

Recent review of the appropriateness of UCITS risk management

The on-going challenge to be addressed accordingly with Member States and supervisory authorities is how UCITS can achieve a more harmonised and uniform understanding and application of risk management processes.

Clearly, as a consequence of the extended investment powers of UCITS since 2001, fund managers needed to adjust their risk management processes, especially their risk-measurement techniques accordingly in order to maintain the adequate level of investor protection associated with the UCITS brand. In order to support the general risk management requirements as set out in UCITS III, the Commission issued a Recommendation 2004/383/EC on the use of derivatives that also provided Member States with some general principles of a risk-measurement approach for UCITS.

According to some work done by CESR in 2007 as regards the effectiveness of existing regulatory framework (UCITS III + Commission Recommendation 2004/383/EC) in harmonising risk management practices among Member States, indicated there was a clear indication that there was a **lack of harmonization in the Member States' regulatory practices on risk management measures and a high level of divergence regarding the**

[115] The European Commission submitted a proposed for Directive on Alternative Investment Fund Managers in April 2009, currently in the co-decision process.

implementation of related provisions of the UCITS III Directive and the Commission Recommendation. This has further been confirmed by conclusions of the study on a comparative analysis of the use of investment powers by UCITS.[116] Both of these findings revealed dangers of possible regulatory arbitrage and investor detriment stemming from a wide room for interpretation (see box 4 for further details).

To achieve higher level of supervisory convergence, a special taskforce was set up in early 2008 within CESR to concentrate on the key areas where further harmonisation was required. The objective of CESR was broadly twofold:

– Establish a Framework for Risk Management Policy to cover the following key features and principles: a) organisation and processes, b) objectives and techniques, c) reporting and advice, d) the link between risk management and valuation and e) supervisory review (CESR launched consultation on the Draft Risk Management Principles for UCITS in August 2008 and published final document in February 2009[117]. The publication coincide with the Commission issuing a mandate to CESR for advice on the content of the level 2 implementing measures).

– Elaborate on specific technical and quantitative guidance regarding UCITS portfolio parameters, namely calculation of the overall exposure according to the commitment and VaR approach, calculation of leverage and calculation of counterparty risk (consultation on Risk measurement for UCITS launched in June 2009 as part of CESR's work needed for the advice to the Commission on level 2 measures for UCITS in the Risk Management area)

– The overarching objectives for CESR at that time was to create a robust framework for the industry as well as supervisory authorities in the risk management area by harmonising key features of Risk Management Policy and Risk Measurement Methodologies across Member States by adopting level 3 guidelines. Both the Risk Management Policy Guidelines as well as the extensive work undertaken by CESR in converging risk measurement techniques feed into this impact analysis.

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[116] Please refer to Annex I, section 3.2.1 for more details as regards the content and key findings of the study

[117] CESR Guidelines (February 2009) - Risk management principles for UCITS http://www.cesr.eu/index.php?page=document_details&from_title=Documents&id=5620

8. AREA B: PRE-CONTRACTUAL DISCLOSURE

8.1. ISSUE 3: Ineffective and inconsistent investor disclosures

Background

Information asymmetries exist between providers and distributors of UCITS and investors in those UCITS (notably retail investors). These asymmetries mean investors are at a structural disadvantage.

Poorly informed investors may buy or be sold products that are not suited to their needs, for instance products which carry more or less exposure to certain risks than anticipated. The consequences of mis-selling and mis-buying are not only felt by individual retail investors, but can reduce UCITS market efficiency, e.g. due to a lack of demand-side discipline on fund pricing, or by leading to reduced confidence in investment markets more generally, with concomitant impacts on capital market efficiency. Overall, unmitigated information asymmetries could lead to reduced investment options and a reduced capacity for the capital markets to fuel the development of the EU economy more widely.

The financial crisis has underlined the crucial importance of these issues, as the crystallisation of risks during the crisis has exposed cases of mis-selling and mis-buying, for instance where consumers have come to realise they were exposed to investment risks that they did not expect.[118]

These issues are compounded by demand-side problems -- retail investors face great difficulties understanding and using information about financial services and products. Evidence shows that retail investors find the vocabulary and style of language typically used in describing financial services and investments difficult to understand and indeed in some cases the language can be misleading.[119] Information is often presented in a legalistic way or in a manner that is un-engaging, for instance so that it is difficult to distinguish between key messages and so-called 'boiler plate'. Information is also often presented in different ways by different product providers, making it very difficult to use the information to shop around or compare products. Financial literacy is generally low, yet information is often pitched at a level that does not take this into account.

For all of these reasons, retail investors very often fail to use information which is provided to them about investments, or where it is used, the information is misunderstood. Three dimensions thereby arise in regards investors' use of

[118] For wider evidence on this point, please see the Commission's Communication on Packaged Retail Investment Products and associated impact assessment: http://ec.europa.eu/internal_market/finservices-retail/investment_products_en.htm.

[119] For example, investors can be confused as to the degree of 'protection' a 'bond' has given the commonplace meaning of the word bond, while fine gradations and limits to guarantees can easily be overlooked; for instance a product labelled as 'guaranteed' will naturally be assumed to be safe from capital loss even if the guarantee has limits; see for an excellent example the Commission's consumer research on options for the Key Investor Information, http://ec.europa.eu/internal_market/investment/investor_information_en.htm. This research reinforced the findings from other research with investors, which have shown the strong impact that low investor financial capabilities can have in regards the retail markets.

information: engagement (is the information presented so as to engage with retail investors?), understanding (is the information capable of being understood by retail investors?), and comparability (is the information presented in a common way so that comparisons can be made?).

The simplified prospectus, as required for all UCITS funds prior to UCITS IV, was intended to address these issues. However, as the Impact Assessment for UCITS IV level 1 outlined, the Simplified Prospectus failed in this. Notable issues that have emerged include:

- Simplified Prospectuses have typically been overly long, legalistic in tone, and difficult for retail investors to understand or use. The layout and format was often off-putting.

- Requirements on the simplified prospectus were not strongly harmonised and nor was the document standardised. As a consequence the documents have been developed in different ways across different jurisdictions and by different UCITS firms, so that retail investors may find it difficult to compare the information from one jurisdiction or fund with that from another.

- Cost disclosures (using a 'Total Expenses Ratio' measure) were not fully harmonised across jurisdictions, so figures were calculated differently in different jurisdictions, reducing transparency and the capacity of investors to compare on an equal footing between two funds.

- Information about risk was also handled differently across jurisdictions, e.g. with some requiring synthetic indicators to be provided, yet calculated according to different methodologies, so that the information cannot be compared. Narrative information on risk was lengthy and seldom contained any indications as to the materiality of different risks for the retail investor, rendering the information next to useless for the average investor.

- Differences between jurisdictions emerged in regards the delivery of the document to retail investors (e.g. over whether the document has to be physically provided, or could merely be offered).

- Differences between jurisdictions have increased costs for firms operating cross-border, and operated as a barrier to cross-border business.

- It is notable that the Simplified Prospectus was developed as a disclosure requirement for the benefit of retail investors without recourse to consumer testing, and so without specific evidence as to the key information that investors need and the effectiveness of different options for showing that information.[120]

Level 2 issues

The level 1 framework requires the Commission to propose implementing measures to exhaustively standardise a replacement for the Simplified Prospectus, so as to address

[120] For discussions of these problems, see the material prepared for the Simplified Prospectus workshops that is made available on this page: http://ec.europa.eu/internal_market/investment/investor_information_en.htm.

these issues; this replacement is known generically as ‘key investor information’ (KII).

The level 1 framework establishes that the KII document shall be a short standalone pre-contractual document, written in plain language, and focused on the needs of the retail investor. It establishes that the form and content of this document will be extensively defined through detailed implementing measures at level 2. It identifies the key elements of the document – information about the fund and its investment policy and strategy, information about its risk profile and potential rewards, information about performance, information about costs, and other practical information about the fund (e.g. where to find out more, who the depositary is, etc.)

The key issue to be addressed at level 2 remain the same as at level 1 – ineffective disclosures and as outlined above. The most important difference between the level 1 issues and level 2 is that at level 2 the concern is with determining the most effective form and content for the standardised document.

Sub-issues to be addressed at level 2

The core information about a fund contained in the KII can be broken down into three broad areas: what the fund is and how it works, its risk profile (and potential performance), and how much it costs. In each of these areas there are particular challenges.

- In regards understanding what the fund is and how it works, key challenges relate to the clarity and succinctness of language used.

- Understanding the risk (and potential for reward) of an investment product is central to making an informed investment decision. The nature of the risk-reward trade off can be complex. For instance, extreme outcomes are possible; recent events have shown the potential importance of rare but extreme outcomes for investors. KII consumer research showed that risk information is particularly difficult for retail investors to understand.

- Consumer research shows that information about costs is often not a central focal point for investors. Investors typically find the information difficult to understand and use. Yet costs are central to outcomes; the relative high costs shown in the UCITS market compared with, say the US mutual fund market raise concerns as to the transparency of costs in the UCITS market and the cost sensitivity of investors in that market.

Given the importance of addressing these challenges, proposals for implementing measures were developed through the use of a consumer testing programme. This was conducted iteratively, so that policy options could be repeatedly developed, tested and refined or abandoned in the light of evidence from consumers themselves. A number of clear alternative approaches emerged in relation to the overall approach, and the specific provision of information on risk, performance, and costs. Options in these areas will be analysed in this impact assessment as sub-issues, as the choice between these alternative approaches – finding the best means for informing investors – was central to CESR's work on KII and consultations on this work.

ISSUE 3: Policy options

Rules on detailed content and form of key investor information	
Sub-issue 3.1: Overall approach	
Baseline	The (counterfactual) baseline for assessing options is the current framework, in which the Simplified Prospectus is only loosely harmonised and is not standardised, though there is a common content and a EU recommendation outlines detail on cost, risk and performance disclosures. This option is not however valid in the context of level 1.
Option 3.1.2 – Tightly standardise the layout / format of the document as a whole	Develop strongly structured and standardised requirements, e.g. on length, order of key items, content of items, headings for sections, font sizes, etc.
Option 3.1.3 – Adopt a more flexible approach	Adopt a more flexible approach, where content and form of particularly elements of information – e.g. risk or cost – are standardised, but where overall form / order of information is not. (Flexibility for distributors to use these 'building blocks' and responsibility for final disclosure addressed through MiFID).
Sub-issue 3.2: Risk information	
Baseline	The baseline for assessing options is the current framework, in which narrative text is required and a synthetic indicator can be used / required by member states, but is not mandatory. Level 1 however requires more detailed implementing measures in this area, so the baseline is purely included for the purposes of analysis.
Option 3.2.2 – Narrative risk disclosure	Under this option, narrative information is provided, but according to a more harmonised / standardised framework.
Option 3.2.3 – Disclosure of risk using a synthetic indicator	Under this option, a single 'synthetic indicator' is shown, locating all funds into a series of 'buckets' or categories (from 1 to 7) according to level or risk / potential reward.
Sub-issue 3.3: Performance Scenarios	
Baseline	The simplified prospectus contains no requirements for the presentation of performance scenarios. Level 1 requires implementing measures in this area.
Option 3.3.2 – Back-	Under this option, historic asset data is used to calculate the

testing	performance of the fund if it had been launched in the past.
Option 3.3.3 – Performance scenarios	Under this option, a range of prospective scenarios are shown, designed to illustrate how the fund might perform (e.g. under weak, medium or strong market conditions).
Option 3.3.4 – Probabilities Tables	Under this option, a range of prospective scenarios are shown, designed to illustrate how the fund might perform by calculating and showing, using complex monte-carlo simulations, the probabilities of different possible outcomes.
Sub-issue 3.4: Charges information	
Baseline	The baseline for assessing options is the current framework, in which the Simplified Prospectus is only loosely harmonised and is not standardised, though there is a common content and a EU recommendation outlines detail on cost, risk and performance disclosures. Level 1 requires implementing measures in this area to harmonise the approach.
Option 3.4.2 – Structured presentation	This seeks to present information in as simple but comprehensive a format as possible, while strongly harmonising the content of the information included.
Option 3.4.3 – Structured presentation with addition of costs shown in cash terms	This seeks to supplement option 2 with a presentation in cash terms, as some research indicates that retail investors respond more strongly to information about charges shown using cash figures.

ISSUE 3: Discussion of policy options

Sub-Issue 3.1 – Overall Approach

Greater harmonisation and standardisation of requirements are likely to lead to certain important benefits.

Harmonisation is likely to reduce the scope for cross-border inconsistencies in requirements applying to UCITS, thereby ensuring minimal barriers to cross-border sale of UCITS. It also ensures consistent requirements apply in all jurisdictions, ensuring that consumer protections standards are always at the appropriate level. This would facilitate an efficient notification procedure, and indeed all areas of cooperation between supervisors where pre-contractual information is concerned.

Standardisation in pre-contractual information ensures that information is presented in a similar manner by different UCITS, domestically and cross-border. There can be different degrees of standardisation – e.g., standardisation can be of either / both form and content, and there can be significant differences in the extent of the standardisation, running from a general requirement to use the same structure, say, to detailed requirements to use a particular highly-defined template.

Standardisation provides for benefits for investors when making comparisons – e.g. the pre-contractual disclosures from different UCITS will, if standardised, look similar, enabling quick comparisons. The consumer testing completed by the Commission confirms this general point: greater standardisation enabled better performance on comparison tests. Standardisation also provides a consistent basis for the future development of financial education programs, and mechanisms for ensuring UCITS disclosures always comply with minimum standards that are set to a high level. It can thereby may help raise levels of comprehension and engagement.

Standardisation also has the benefit of potentially reducing costs for firms (and regulators), as there would be greater legal certainty over the content and form of disclosures that are compliant with requirements, lowering compliance costs. However, the Commission's study on the costs of replacing the SP with the KII (based on a mock up of the final KII that reflects the retained options identified in this impact assessment) did not identify overall savings: in fact the KII was expected to average costs that were 7.5% greater than the SP;[121] of course a definitive picture of costs may only be possible *ex-post*.

Issues with standardisation

Standardisation may impact negatively on investors should this standardisation overly simplify a product's functions or risks, or be insufficiently tailored to the product's features to provide key information in an easy to read form. The Commission's consumer testing of KII proposals sought stakeholder views precisely on this possibility: however, it found no evidence to support the conclusion that greater standardisation for UCITS would impair investor protection measures. Indeed, the contractors concluded that standardisation would be an effective mechanism for ensuring that the standards of documents were raised.

In addition, overly-harmonised and standardised requirements may lead to unintended duplication of disclosures or ineffective overall disclosures, e.g. where tax wrappers are used. A more flexible approach to disclosure requirements which does not standardise the overall approach to the information to be provided might be able to more readily address these situations.

Conclusion

Given that UCITS are in broad terms 'harmonised products' – such that their legal nature and functioning as products can be generally known to be consistent across all jurisdictions – the investor protection risks of standardisation are reduced, while the benefits are more readily achievable. Given the potential for reduced costs for UCITS (and to a degree supervisors) through more standardised requirements, and the benefits in regards cross-border trade and notification procedures from harmonisation, there is a strong case for adopting a strongly harmonised and standardised approach (though with sufficient flexibility to encompass the wide range of investment policies and strategies that can be adopted by UCITS).

[121] As yet unpublished and unfinalised study, CSER, on costs of the KII. (See Annex I.3.1). [Full reference to be included once published].

Standardisation in general places a greater emphasis on the quality and contents of the standardised requirements – the content of these must be appropriately developed and effective, otherwise benefits of standardisation are unlikely to be achieved. The remainder of the options that are examined in regards the KII relate precisely to different approaches to the key information in the KII – information on risks, costs and performance.

Sub-Issue 3.2 – Risk information

Use of a synthetic indicator

A synthetic indicator presents the level of risk in a fund through a simple scale consisting of a series of 'buckets' or categories, and focuses on market risk. This means the presentation is potentially simplifying risk into a single metric, and this simplification could raise comprehension issues, for instance where an investor relies on the indicator to the exclusion of other messages about important risks. Also, any indicator cannot with full accuracy predict risk levels (for KID, CESR have proposed a ex-post measure that uses historic volatilities of NAV figures as its basis), and the level of risk indicated for the fund may not in all cases match future levels of volatility.

A rating however offers a consistent way of showing a funds riskiness that aids comparisons between funds, in an engaging manner that investors are likely to be able to use and comprehend. While other many risks might be relevant overall, information about the basic potential for losses that goes along with a fund's potential for greater gains is of core importance.

The KII consumer testing research showed that a synthetic indicator increased investors' engagement with the information whilst there was no significant impact on levels of understanding – investors appeared as able to correctly answer questions relating to comprehension of risk as those shown a purely narrative disclosure. Investors themselves strongly preferred a presentation using a synthetic indicator.

For a synthetic indicator to function as a means for comparison, it is vital that it is always calculated in the same manner, requiring a harmonised approach to the calculation of the risk category for each fund. Any such methodology greatly enhances the level playing field between funds, though it would be important that the methodology does not mis-rank different types of fund, or understate the levels of risk likely for particularly asset classes. Any such methodological weaknesses would likely lead to investor detriment.

A harmonised methodology and standardised presentation may reduce compliance costs for firms in some cases, given that the proposed methodology is objective and common, requiring reduced compliance work by individual funds. Initial costs would be higher than the SP as systems are put in place and tested for compliance. Data providers who may already provide services to UCITS in relation to performance information would likely be able to include fund risk ratings as an element of their service.

Use of a narrative approach

A narrative approach to risk disclosure favours an in principle more nuanced presentation that can reflect the different dimensions of risk that may be relevant for a fund without overly highlighting and single dimension. Evidence from the consumer testing was that this approach could lead to marginally better understanding, particularly with more sophisticated investors, but that it was not preferred by investors and was found less engaging. It was generally seen as more difficult to compare between funds on the basis of a narrative approach.

Costs for industry may be higher under this approach than under the Simplified Prospectus, given the extent that greater work is required drafting an effective text in consistency with plain language requirements.

A narrative approach would not entail the development of calculation methodology that might prove faulty, though key messages about relative levels of risks would not be as effectively communicated as with an indicator (e.g. basic messages that certain funds are relatively high risk and carry a greater potential for a loss of capital invested). Given levels of investor understanding this weakness is important and significant.

Conclusion

Given the evidence that a synthetic indicator performs roughly as effectively as a narrative presentation in communicating complex messages, but is considerably more engaging and more readily useable for comparisons, from a consumer protection perspective it provides the best balance in communicating information about risk. For other stakeholders the use of a synthetic indicator may raise concerns as to the soundness of supporting methodology, so it is vital that this methodology is reviewed and developed in the light of further experience.

For UCITS, while the synthetic indicator may require some additional work on introduction, an objective and highly harmonised approach should provide greater legal certainty and some reduction thereby in costs.

Sub-Issue 3.3 – Performance information for structured funds

Backtesting, Performance Scenarios and the use of probabilities

Structured funds can be extremely complex and difficult for retail investors to comprehend, though the basic principle – to use derivative contracts and other financial techniques to provide ‘down-side’ protection, though at the cost of reduced participation in any ‘up-side’ gains – is relatively simple. The pay out from these funds is generally governed by a formula.

Given the complexity of these funds and the mechanisms by which they work, it was considered vital to include additional information on potential performance to aid investors in making an informed investment decision about them. Three basic approaches can be envisaged to providing such information: an approach based on simulating the return of the fund using historic market data (back-testing); an approach based on picking a range of possible future scenarios and illustrating how they fund would perform if these scenarios came true; and, finally, an approach, similar to the second, where stochastic simulations are used to establish, according to the assumptions used for these simulations, the likely probabilities of these scenarios.

All three approaches raise comprehension challenges for retail investors: back-testing is problematic because it can be misleading as to likely outcomes, given the structure and pricing of the structured fund is based on present market conditions, rather than those in the past; performance scenarios can be misleading as it can be difficult to establish the relevant scenarios to be chosen, and to communicate the likelihood of these scenarios coming about; on the other hand, probability tables which try and show likeliness can be difficult for investors to use (low levels of understanding of probabilities) and/or appear to create a promise or a prediction that investors overly rely on.

The KII consumer testing sought feedback on the presentation of this information. Investors were poorly able to use back-testing information, as they found it difficult to establish the relevance of the information or how to use it in thinking about likely future performance. Investors responded better to tabular presentations of performance scenarios; graphical presentations were less easy for most investors to use. The testing showed that while some investors might prefer information about the likelihood of outcomes, in practice most found this information difficult to use.

Technical issues arise however with the use of probabilities – these require complex simulations and that are sensitive to a number of basic economic assumptions. Given the complexity of these simulations it would be extremely difficult to fully harmonise requirements at the EU level, yet a lack of harmonisation would potentially lead to cross-border differences in approach between Member States and a lack of consistency in the information provided to investors. It would be difficult for supervisors to reverse-engineer the information provided and effectively supervise it.

For UCITS, back-testing approaches may be the technically easiest to prepare, and scenarios with probabilities the most complex. CESR's consultation with stakeholders was strongly in favour of the use of scenarios without probabilities.

Conclusion

As set out, retail investors clearly better understood and preferred the use of scenarios (with tables rather than graphs) rather than back-testing. Adding probabilities to these tables might increase retail investor comfort and engagement with the information, but it would not clearly lead to improved comprehension and would lead also to problems with consistency and comparability of information, given the large number of assumptions necessary in producing such information.

Sub-Issue 3.4 – Charges information

Structured approach

The structured approach to the presentation of charges consists in a strong standardisation of the presentation of the information, including the use of a common table structure with circumscribed descriptions and labels. Central to this approach is the provision of a 'ongoing charges' figure which, for most ordinary funds, is the key focal point; for this a common methodology is proposed to ensure consistently calculated figures are provided. This offers a single core focal point for retail investors, and a level playing field between funds so that fair comparisons of cost can be made.

The common format should foster comparisons, making it much easier to use cost information to assess different funds. Improved consistency in the calculation of ongoing fees (hitherto known as TERs) should reduce market distortions; increased transparency on costs could lead to a more competitive fund market, leading to wider benefits for retail investors (i.e. better returns). More standardisation and harmonisation should aid supervisors in assessing compliance of funds, and reduce some costs for UCITS, e.g. when selling cross-border. Greater legal certainty over the necessary content of the KII compared to the SP could also potentially reduce compliance costs.

This approach would require changes for firms in some jurisdictions to their fee calculation systems.

The KII consumer testing showed that a structured approach to charges information aided retail investors in making comparisons, and that the simpler the information was the more likely it would be that retail investors would be willing to use it for comparisons.

Addition of cash disclosures

Given the difficulties investors face in understanding and using cost information, it was examined whether an ‘example’ or illustration of the combined costs in cash terms might be useful.

To develop this approach and also provide information as to the impact of costs over time, a presentation was developed in which costs borne by the investor directly and ongoing costs borne by the fund were combined on the basis of certain assumptions (e.g. over investment amount, investment period, and rate of return on the fund). The KII consumer testing confirmed that investors typically respond to information in cash terms more directly than information in percentage terms, as many retail investors are poor at gauging the impact of percentage charges, for instance underestimating the impact over time. Consumers expressed a strong preference in questionnaire answers and focus groups for information in cash terms, yet were not necessarily able to use the information presented in this form.

The KII consumer testing showed that this information aided investors in comparing certain funds when shown in isolation, by aiding the investor in combining entry costs and ongoing costs and seeing the impact of costs over time. However, when the cost information was combined into a mock up of a complete KII, investors found the cash disclosures off-putting and complex, and did not perform any better (and in some cases performed worse) when asked comprehension questions. In addition, the information may often be misleading for investors since the actual costs they will pay will typically be different due to discounting of disclosed entry costs.

The addition of such disclosures would be additional costs for UCITS, as they do not currently form part of the Simplified Prospectus.

Conclusion

Given the weak outcomes in consumer comprehension and engagement where cash disclosures were included in complete mock-ups of the KII in the testing, it was considered that the best balance between effectiveness and efficiency would be to exclude this information from the KII.[122]

ISSUE 3: Conclusions

The conclusions for each sub-issue have been covered separately.

Overall, the Commission study on KII costs shows that the changes necessary for bringing in the KII – systems changes, training costs, printing costs, drafting costs, etc. – are expected to lead to ongoing costs that are on average around 7.5% greater than the SP.[123]

The study estimated that a maximum for the overall cost of introducing the KII will be in the region of 0.016% of AUM, or 730 million EUR, in so far as there is no further consolidation of the number of funds, and in so far as KII are produced for all existing funds – this is a conservative assumption, since many existing funds may be in the process of being run down; the report estimates that the cost figure could instead be as low as 290 million EUR.

Ongoing costs would be in the region of 350 million EUR.

The investor benefits – ultimately flowing from more informed decision making, reduced detriment, greater confidence and lower complaints – are extremely difficult to quantify *ex ante*.

In needs to be pointed out that these costs are not originating from the solutions as retained within the individual sub-sections in this analysis. These costs are originating from level 1 requirements.

ISSUE 3 Summary of analysis

Policy Options	Effectiveness in achieving the relevant objective: Maximise comprehension, engagement and use of document for comparisons			Efficiency
	Comprehension	Engagement	Comparisons	
Sub-Issue 3.1 Overall Approach				
Baseline	0	0	0	0
Option 3.1.2: Highly standardised / harmonised document	+	+	++	+
Option 3.1.3:	+/=	+/=	+	=
Sub-Issue 3.2 Risk Information				
Baseline	0	0	0	0
Option 3.2.2: Synthetic indicator	+	+	++	+/=
Option 3..2.3:	+/=	+/=	+/=	+/=
Sub-Issue 3.3 Performance scenario				
Baseline	0	0	0	0
Option 3.3.2:	-	+	-	=

[122] CESR also consulted on a simpler version of the cash disclosure (without showing a range of scenarios for different time horizons); however feedback from many stakeholders, but not from investor representatives, was strongly negative, questioning the added value of this disclosure and suggesting it would further confuse retail investors and complicate the document.

[123] As yet unpublished and unfinalised study, CSER, on costs of the KII. (See Annex I.3.1).

Option 3.3.3: Performance scenarios	+	+	+/=	+/=
Option 3.3.4:	-	+/=	+	+/=
Sub-Issue 3.4 Charges				
Baseline	0	0	0	0
Option 3.4.2: Structured Presentation	+	++	++	+
Option 3.4.3:	+/=	+	+	+

Magnitude of impact as compared with the baseline scenario: ++ strongly positive, + positive, -- strongly negative, - negative, = marginal/neutral,? uncertain, n.a. not applicable

9. AREA C: MERGERS AND MASTER-FEEDER STRUCTURES

9.1. ISSUE 4: How investors receive information about the merger of UCITS in which they invested (4.a) and about the conversion of UCITS to feeder or on a change of the master UCITS (4.b)

Mapping of Member States regimes indicate that in majority of them UCITS may issue only registered shares, in other UCITS may issues also bearer shares that are dematerialised or in a physical form:

- (i) Registered shares of UCITS

In a majority of Member States (BG, CY, ESP, EST, FIN HU, IRL, LUX, LV, LT, PL, PT, RO, SK) UCITS may only issue registered shares/units.[124] In other Member States (AT, BE, CZ, DE, DK, SE, UK[125]), UCITS may choose to either issue registered or bearer shares. In all cases of registered shares the UCITS or its management company knows who its unit-holders are and the register contains their mail and/or electronic addresses.[126] The UCITS or its management company can therefore directly provide the information to unit-holders.

- (ii) Dematerialised bearer shares of UCITS

- The situation is typically more complicated where the UCITS issues bearer shares, since the UCITS or its management company do not know who its unit-holders and, for practical or legal reasons (e.g. HU), cannot directly contact unit-holders. UCITS may for instance issue bearer shares in AT, BE, CZ, DE, HU however the vast majority of bearer shares are nowadays dematerialised. This means that typically banks or other intermediaries subscribe units on behalf of a number of end-investors without passing on the names/contact details of those end-investors to the UCITS, its management company or the depositary, as the case may be. In some Member State the passing on of names/contact details is not permitted (e.g. AT, due to banking secrecy). In a few cases the bank or other intermediary becomes itself the unit-holder (i.e. the legal owner). This exceptional case causes no problems, since the bank/intermediary is known to the UCITS or its management company and information can be provided in a cost efficient way. However, in the majority of cases the end-investors are the unit-holders of the UCITS. In those case it would not suffice to provide the information to the bank/intermediary (which is known to the UCITS/management company), but to each end-investor (which is only known to the bank/intermediary). This means that the UCITS or its management company will need the help of a third party (the bank/intermediary or other entities) in order to provide the information to unit-holders. Whether and how the bank/intermediary has to inform the end-investors is currently subject to national law. Some Member States (e.g. SE) oblige the bank/intermediary to pass on the information to the unit-holders. In other Member States no specific provisions exist. However, also in those Member States there are

[124] Please note that the terms shares or units are used here as synonyms.

[125] However, the UK authorities informed us that all UK UCITS actually have issued registered shares.

[126] The UCITS or its management company typically maintains the register itself. In some Member States the maintenance of the register can be carried out by a third party, but the UCITS or its management company has always access to the register.

channels available which can henceforth be used to provide information to end-investors (e.g. through the custody, transfer agent or distributor chain). Those channels are already in use for the subscription and the request for redemption of units as well as the payment of dividends or redemption proceeds.

- (iii) Physical bearer shares of UCITS

- In Belgium, Czech Republic and eventually in a very limited number of other Member States[127] there are currently still UCITS bearer shares in physical form in use. In this exceptional case the identity and contact details of the unit-holders are typically not registered. Those unit-holders are neither known by the UCITS or its management company nor by the bank which subscribed the units on their behalf. As a consequence, it is not possible to personally address information to those unit-holders. When those unit-holders wish to receive dividends, they need to cash in physical coupons for which they need to open a bank account dedicated to this purpose. Belgian authorities announced however that for these shares the final deadline for the conversion into dematerialised bearer shares is 31 December 2013. As of 1 January 2014 at the latest information can be provided to all unit-holders in Belgian UCITS as described above under (ii).

- As the mapping of Member States regimes in respect to the provision of information in cases of domestic UCITS mergers shows, eleven Member States require an active way of providing information to unit-holders (CZ, DK, ESP, FI, FR, IRL, IT, LT, PT, SE, UK) and eleven Member States (AT, BE, CY, DE, EST, HU, LUX, LV, PL, RO, SK) currently allow a passive way of providing information to unit-holders, e.g. via national newspapers, the official gazette or the managers' web site etc. In the latter group of Member States unit-holders are expected to check those newspapers, official gazettes websites etc. at their own initiative, if they want to be informed. Based on the mapping of Member States' regimes, the scale of management companies that could be effectively considered to be already subject to an obligation to address investors in an active way and individually by sending a personalised letter or e-mail could be around 850, which is estimated to represents approximately 60% of all UCITS managers active in these Member States and 40 million of UCITS investors in these Member States (about 55% of about 70 million of UCITS investors).

[127] Please note that no other Member State indicated in its answer to the questionnaire that its domestic UCITS may still have physical bearer shares.

Table 9.1: Overview of Member States regimes applicable with respect to holding UCITS shares and the way in which investors are informed about a domestic merger of UCITS

MS	Assets under Management (end 2008)/ mn EUR*	Number of asset managers (2005)**	Are end investors always the unit holders of UCITS? Or does the national law provide for other ways of holding UCITS shares (e.g. through a nominee)?	Does the UCITS management company (MC) have a register of unit holders?)	In case the the answer to previous qeustion is "NO" and the management company (MC) does not hold the register, is there another entity who can identify the unit holder?	In case of a domestic merger of UCITS, which channels can UCITS/the Management Company currently use to inform unit holders?
AT	**82.482**	**48**	The Austrian Investment Funds Act does not provide for any special way of holding UCITS shares - UCITS shares can be held just like any other securities. The final investor is usually the unit holder of the UCITS.	NO	Yes, custodian bank	passive
BE	**86.646**	**47**	As far the nominative shares are concerned, the Belgian legislation does not prohibit the use of a nominee. In such case, the end investor is not the legal owner of the UCITS units. Except in the case of a nominee structure, there is no other regime in which the end investor would not be the legal owner of the UCITS units.	NO	Yes, an entity that keeps a register of shares (transfer agent)	passive
BG	**177**		Usually the unit holders of UCITS are end investors.	**YES**	N.A.	no cases of domestic merger
CZ	**4.376**	**7**	The end investors are always the unit holders of UCITS. UCITS units can be issues in dematerialized or materialized form but have a form of “securities au nom” but also in materialized form but "au porteur". In fact, the UCITS units are being dealt by a bank belonging to the same concern as the management company (Czech UCITS are always managed by a management company, as they can't be legal persons presently). Such bank markets the units and it is the management company that keeps the independent accounts for the investors.	**YES** - if units are dematerialized or materialized but have a form of “securities au nom”. NO - if f the UCITS units are materialized and "au porteur".	Yes, the bank, which keeps the accounts for all unit holders.	**ACTIVE:** the management company notifies the bank, which keeps the accounts for all unit holders. The unit holders are informed by the mnagement company itself or by the bank.
CY			Up to now there are not domestic UCITS established and operating in Cyprus, however, there are foreign UCITS marketing their units in Cyprus through local distributors. Thus, the unitholders of foreign UCITS in Cyprus may not always be the end investors based on arrangements with distributors	**YES**	N.A.	passive

MS	Assets under Management (end 2008)/ mn EUR*	Number of asset managers (2005)**	Are end investors always the unit holders of UCITS? Or does the national law provide for other ways of holding UCITS shares (e.g. through a nominee)?	Does the UCITS management company (MC) have a register of unit holders?)	In case the answer to previous question is "NO" and the management company (MC) does not hold the register, is there another entity who can identify the unit holder?	In case of a domestic merger of UCITS, which channels can UCITS/the Management Company currently use to inform unit holders?
DE	**220.424**	**141**	In Germany units may be issued in the form of either registered or bearer securities. When a bearer security is issued - the normal case in Germany - the represented right merges with the written document. Consequently, a bearer unit is a form of tangible movable property. The right attached to registered units is not represented by a physical document.	NO	Yes, custodian but also other third party	passive
DK	**58.032**	**28**	End investors are not always the unit holders of a UCITS. Thus, a nominee can be a unit holder.	**YES, usually**	Yes, central securities depository	**ACTIVE** (written to unit holders) but also passive
ESP	**187.152**	**120**	End investors are always the unit holder of UCITS, except in the border marketing of Spanish UCITS.	**YES**	N.A	**ACTIVE** (letters sent to investors)
EST			Usually end investors are the unit holders, but it is possible to hold the units in the name of nominee or intermediary.	**YES,** but not always	Yes, intermediary or owner of nominee account	passive
FI	**45.905**	**27**	In the book-entry system units can be registered in the name of a nominee. In practice, nominee registration of unit-holders is not used. - At the moment there is a draft bill currently discussed at the Parliament to allow nominee ownership in UCITS and non-UCITS. This possibility is applied to foreign unit-holders only	**YES**	N.A	**ACTIVE** and passive
FR	**1.253.395**	**323**	The end investors are considered as the unit holders of UCITS. The system of nominee does not exist in the same way as in other jurisdictions.	NO	**Yes.** The only entities who know the identity of the end investors are the custodians. There is however a procedure, in the legislation, which ensures that the management company can obtain, under request, the identity of the unit holders	**ACTIVE**

MS	Assets under Management (end 2008)/ mn EUR*	Number of asset managers (2005)**	Are end investors always the unit holders of UCITS? Or does the national law provide for other ways of holding UCITS shares (e.g. through a nominee)?	Does the UCITS management company (MC) have a register of unit holders?)	In case the answer to previous question is "NO" and the management company (MC) does not hold the register, is there another entity who can identify the unit holder?	In case of a domestic merger of UCITS, which channels can UCITS/the Management Company currently use to inform unit holders?
HU	**8.366**	**21**	Yes, the end investors are always the unit holders of UCITS. Since the investment company structure (where the investors own shares of a company) doesn't exist in Hungary, there are no other ways of holding UCITS units.	NO	Yes, the distributor (investment firm or credit institution)	passive
IRL	**597.331**	**53**	In Ireland the end investor will no necessarily be the legal owner of shares/units in the UCITS. The legal owner is the individual /isntituion included in the unit holder register of the UCITS. There is no prohibition in national legislation on the use of nominee arrangements. In such cases the nominee is the legal owner of shares/units in the UCITS.	**YES**	N.A.	**ACTIVE**
IT	**193.998**	**103**	In general yes end investors are usually the legal unit holders. Except for the case if the unit holders ask for a individual paper certificate (rearely).	**YES**/no	Yes, depositary	**ACTIVE** (individual letters or management company journals)
LUX	**1.592.373**	**235**	End investors are not always the unit holders of UCITS. Shares are often held through nominees.	**YES**	N.A.	passive
LV			End investors are always the unit holders of UCITS. The national law does not provide for other ways of holding UCITS shares.	**YES**	N.A.	passive
LT			Yes, they are. According to national legislation, end investors are always the unit holders of UCITS.	**YES**	N.A.	**ACTIVE (written to unit holders)** and passive

MS	Assets under Management (end 2008)/ mn EUR*	Number of asset managers (2005)**	Are end investors always the unit holders of UCITS? Or does the national law provide for other ways of holding UCITS shares (e.g. through a nominee)?	Does the UCITS management company (MC) have a register of unit holders?)	In case the answer to previous question is "NO" and the management company (MC) does not hold the register, is there another entity who can identify the unit holder?	In case of a domestic merger of UCITS, which channels can UCITS/the Management Company currently use to inform unit holders?
PL	**16.020**		End investors are always the unit holders of UCITS. There are no other ways of holding UCITS units such as nominee structures in Poland.	**YES**	N.A.	passive
PT	**11.572**	**20**	Normally, unit holders are end investors although, according to Portuguese law, nominees are generally accepted. Additionally, investments of institutional investors like UCITS or individual portfolio management entities are allowed and can result in similar situations. In those cases the same duties and rights of individual unit holders apply.	**YES,** if marketed by the management company. NO in other cases.	Yes, custodian (if marketed by others)	**ACTIVE** (advice to unit holder individually of a prospective merger) and passive
RO	**791**		According to the Romanian legal provisions in force the end investors are the unit holders of UCITS. The national law does not provide for other ways of holding UCITS units.	**YES**	N.A.	passive
SE	**123.533**	**59**	Insurance providers could be considered as unit holders. In all other cases end investors are considered to be unit holders, i.e. the legal owners. National law, however, provides for holding units through a nominee. In that case the nominee would be registered in the unit-holder register.	**YES**. NO if the nominee is registered.	Yes, nominee is obliged to pass the information from MC directly to end investors	**ACTIVE**
SK	**3.255**		No. Law provide both options - direct or indirect holding of UCITS units or shares (through nominees accounts). In practice direct holding is preferred.	**YES**	N.A.	passive
SLO	**1.842**					
UK	**533.506**	**111**	UK law and regulation recognise that the unit holder may not necessarily be the end investor (i.e. the beneficial owner of the money invested in the fund). Nominee companies are frequently used (egg by discretionary portfolio managers and platform operators) and many UK management companies are encouraging investors to move to this arrangement to reduce the costs of maintaining the register of unit holders. UK regulation provides for the possibility of an authorised fund issuing bearer units (i.e. unregistered units identified by a bearer certificate), but no fund actually does so. There are no provisions in our regulations for requiring another entity to be able to identify or contact the holders of the bearer certificates.	**YES**	Also the trustee	**ACTIVE**

Table 9.2: Overview of the UCITS market in number of managers, funds and investors

Member State	Number of asset managers*	Number of UCITS funds domiciled in a MS**	Number of non-UCITS funds domiciled in a MS**	Number of all funds**	UCITS Asset under Management (mn EUR)***	*Estimated number of unit holders in UCITS funds*
AT	48	1545	782	2327	82.482	*3.090.000*
BE	47	1788	35	1823	86.646	*3.576.000*
CZ	7	99	2	101	4.376	*198.000*
DK	28	500	269	769	58.032	**591.500**
FI	27	379	137	516	45.905	*758.000*
FR	323	8243	3685	11928	1.253.395	*16.486.000*
DE	141	1741	4246	5987	220.424	**4.640.000**
GR	30	260	10	270	9.191	*520.000*
HU	21	271	50	321	8.366	*542.000*
IRL	53	2898	1882	4780	597.331	*5.796.000*
IT	103	924	370	1294	193.998	*1.848.000*
LUX	235	8782	2333	11115	1.592.373	*17.564.000*
NL	28	481	95	576	66.300	*962.000*
PL		192	165	357	16.020	*384.000*
PT	20	212	283	495	11.572	*424.000*
SK		72	46	118	3.255	*144.000*
SLO		110	7	117	1.842	**302.330**
ESP	120	2940	42	2982	187.152	**8.099.134**
SE	59	540	16	556	123.533	*1.080.000*
UK	111	2321	412	2733	533.506	*4.642.000*
Sub-total	**1401**	**34.298**	**14.867**	**49.165**	**5.095.699**	**71.646.964**
		1.858	*359*		*96%*	
TOTAL EU	**1440**	**36.156**	**15.226**	**51.382**	**5.298.768**	

* ZEW/OEE study, www.oee.fr, **EFAMA year book 2008 (2007 data), *** EFAMA statistics for 2009

10. ADMINISTRATIVE COSTS AND ADMINISTRATIVE BURDEN

We identified 15 information obligations stemming from the implementing measures of the UCITS IV Directive. They are listed below in four sections, according to the legal act which is being modified by these measures. Our screening revealed that 3 requirements (namely obligations 13 to 15 below) have cost implications and are therefore quantified. Our analysis also showed that 12 information obligations (namely those listed from 1 to 12 below) should not be considered as administrative costs and are therefore not quantified. The latter group is also listed below, together with the reasons for not including them in quantification.

10.1. COMMISSION DIRECTIVE No …/..EU implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company

For the purposes of measuring administrative costs imposed by EU legislation, we identified the following 13 obligations:

Article 10 Permanent compliance function

1. The obligation: Article 10(3)b: a compliance officer must be appointed and must be responsible for the compliance function and for any reporting on a frequent basis, and at least annually, to the senior management on matters of compliance, indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies

Article 11 Permanent internal audit function

2. The obligation: Article 11(2)d: the internal audit function shall provide regular reports, and (article 9(4) at least annually on compliance and related matters to senior management

Article 12 Permanent risk management function

3. The obligation: Article 12(3)d: the risk management function shall provide regular reports to the board of directors and the supervisory function at least annually

4. The obligation: Article 12(3)e: the risk management function shall provide regular reports, and (article 9(4) at least annually to the senior management outlining the current level of risk incurred by each managed UCITS and any actual or foreseeable breaches to their limits, so as to ensure that prompt and appropriate action can be taken.

On the basis of the arguments below, it is considered that no material administrative costs will arise from these obligations and they will thus not be included in the quantification of AC/AB.

The preferred option for Issue 1 is to align organisational, conduct of business rules and rules on conflicts of interest with those of the Directive 2006/73/EC implementing Directive 2004/39/EC MiFID. The impact of the preferred option on UCITS management companies will vary, depending to what extent Member States have applied or extended MiFID rules also to UCITS management companies. On the basis of preliminary work conducted by the CESR in 2007, the number of management companies that are domiciled in those Member States that do not align their regulatory requirements with those of MiFID is approximately 470 entities, which constitutes 33% of all UCITS management companies[128], managing 39% of UCITS assets in 38% of funds.

However these estimates may overstate the number of management companies impacted, since (1) robust data on group arrangements is not available, (2) it is not possible to account for those management companies that do both MiFID as well as UCITS individual and collective portfolio management and decided to apply MiFID rules on a voluntary basis (or those that do this for their own reasons - the existence of such firms is evident from replies of several industry associations to the CESR's consultation whose members include companies from those Member States with little or no MiFID alignment). In light of these conditions, it can be assumed that the number of entities could be significantly lower.

Moreover, although the origin of the obligations requiring internal reporting within a management company stems from the requirements of MiFID implementing legislation, these requirements are of a general nature and should in principle be observed also by companies in those Member States that have their own particular obligations with respect to companies undertaking investment management.

Article 13 Personal transactions

5. The obligation: Article 13(2)b and c: the management company is informed promptly of any personal transaction entered into by a relevant person, either by notification of that transaction or by other procedures enabling the management company to identify such transactions. Where certain activities are performed by third parties, the management company must ensure that the entity performing the activity maintains a record of personal transactions entered into by any relevant person and provides that information to the management company promptly on request.

The management company needs to ensure that a record is kept of the personal transaction notified to the management company or identified by it, including any authorisation or prohibition in connection with such transaction

For the reasons below, the obligation to report or notify any personal transactions they are/were involved in and that may raise conflict of interest problems with respect to the management company will not be considered for the calculation of the AC/AB in this report.

It is difficult to predict the frequency upon which these obligation to report arise and also it is very likely that its occurrence will be minimal thus having no material impact in terms of any additional administrative costs arising from this obligation.

Moreover, the level 1 UCITS Directive, article 12(1)a stipulates that management companies shall have rules for personal transactions by its employees its place. The requirements put forward in the level 2 draft Directive can therefore be seen as providing more clarity as to the way how to accommodate in a harmonised way for such situations.

[128] Source: ZEW-OEE database www.oee.fr, data from EFAMA FERI FMI, ZEW calculation of 2005

Article 14 Recording of portfolio transactions

6. The obligation: Article 14(1): management companies shall ensure, for each portfolio transaction relating to UCITS, that a record of information which is sufficient to reconstruct the details of the order and the executed transaction is produced without delay.

Article 15 Recording of subscription and redemption orders

7. The obligation: Article 15(1): management companies shall take all reasonable steps to ensure that the received UCITS subscription and redemption orders are centralised and recorded immediately after receipt of any such order.

Article 24 Reporting obligations in respect of execution of subscription and redemption orders

8. The obligation: Article 24(1): where management companies have carried out an order from a unit holder, they must send the unit holder a notice, in a durable medium, confirming execution of the order as soon as possible, and no later than the first business day following execution or, if the confirmation is received by the management company from a third party, no later than the first business day following receipt of the confirmation from the third party. This requirement shall not apply where the confirmation notice would contain the same information as a confirmation that is to be promptly dispatched to the unit holder by another person. In such a case the management company shall provide the investor, in a durable medium, with the essential information concerning the execution of that order.

9. The obligation: Article 24(3): In the case of orders for a unit holder are executed periodically, management companies shall either take the action specified in paragraph 1 of or provide the unit holder, at least once every six months, with the information listed in paragraph 2 in respect of those transactions

Article 16 Recordkeeping requirements

10. The obligation: Article 16(1): management companies shall ensure the retention of the records referred to in Articles 14 and 15 for a period of at least five years.

As explained below, there is no reason to assume that these requirements will impose any material additional administrative costs and they will therefore not be included in the calculation of AC/AB.

Obligation 6: Article 14 Recording of portfolio transactions

The level 1 UCITS Directive stipulates in article 12(1)a that: "each transaction involving the UCITS may be reconstructed according to its origin, the parties to it, its nature, and the time and place at which it was effected and that the asset of the common funds or of the investment companies managed by the management company are invested according to the fund rules or the instruments of incorporation and the legal provisions in force."

The level 1 obligation in practice mean that in order to be able to reconstruct transactions according to its origin, etc. management companies need to have in place some form of recording of such events in order to be able to comply with the obligations at level 1, which were not changed in the course of the latest amendments to UCITS.

The proposed level 2 measure in this respect does add any material impact in terms of additional administrative costs or burden on management companies and this obligation will not be included in the calculation of AC/AB.

Obligation 7: Article 15 Recording of subscription and redemption orders

Recording of subscription and redemption of orders in UCITS funds is already an existing practice. The differences lie in the various distribution systems and models the UCITS management company is using. Only a minority of subscription and redemption of orders is being handled by management companies directly themselves and there is less than 1% of companies who are concerned. Most of the time these activities are performed by other intermediaries or entities and these are already subject to MiFID rules from where these particular requirements stem from.

The nature of the requirements in Article 15 therefore does not intend to create a new framework of dealing with these activities. Rather its intention is to draw on the existing business practice in dealing with UCITS subscriptions and redemptions in a more coherent manner to ensure that the records of these transactions are maintained recognising the existing market practices. In this way the requirements would not necessarily fall on management companies themselves but on other entities in the distribution channel.

Obligation 8 and 9: Article 24 Reporting obligations in respect of execution of subscription and redemption orders

Article 24 requires management companies to dispatch to investors confirmation of the executed order in a durable media, however this requirement does not apply where the information notice would contain the same information as a confirmation that is to be promptly dispatched to the investor by another person.

The exemption to the rule is in principle confirming the argumentation provided for in for Article 15. Since most of the orders in UCITS are handled by intermediaries who are already subject to MiFID, this level 2 UCITS requirements in fact allows for investors being informed by the intermediary or any other relevant institution.

For the same reasons as above there are no material additional administrative costs being imposed on management companies and this obligation will therefore not be included in the calculation of AC/AB.

Obligation 10: Article 16 Recordkeeping requirements

The requirement to keep records as referred to in articles 14 and 15 is already a standard practice in al Member States. Not least for tax purposes for which records shall be kept between 5 to 10 years.

In this respect, this provision is deemed to be considered only a formal harmonisation of existing practice and should not trigger any substantial additional costs. As in the previous cases, this obligation will not be included for the calculation of the AC/AB.

Article 20 Management of activities giving rise to detrimental conflict of interest

11. The obligation: Article 20(1): management companies shall keep and regularly update a record of the kinds of collective portfolio management activities carried out by or on behalf of the management company in which a conflict of interest entailing a material risk of damage to the interests of one or more UCITS or other clients has arisen or, in the case of an ongoing collective portfolio management activity, may arise.

12. The obligation: Article 20(3): management company shall report situations referred to in paragraph 2 (see below for reference) to investors by any appropriate durable medium and explain its decision.

Article 20(2): Member States shall require that, where the organisational or administrative arrangements made by the management company for the management of conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of UCITS or of its unit-holders will be prevented, the senior management or other competent internal body of the management company is promptly informed in order for them to undertake any necessary decision to ensure that in any case the management company acts in the best interests of the UCITS and of its unit-holder.

In the light of the arguments below, also these obligations are to be considered as non-material in terms of raising additional administrative costs to management companies and they will not be considered in the AC/AB calculation.

It is difficult to predict the frequency upon which these obligation to report arise and also it is very likely that its occurrence will be minimal thus having no material impact in terms of any additional administrative costs arising from this obligation.

Moreover, the level 1 UCITS Directive, article 12(1)b stipulates that: "management companies shall be structured and organised in such a way as to minimise the risk of UCITS or clients' interests being prejudiced by conflicts of interest between the company and its clients, between one of its clients and ……"

In effect, UCITS management companies already have arrangements for dealing with conflicts of interests, but national approaches diverge as to the specificities of how certain procedures should be organised internally. The level 2 requirements only streamline and specify more clearly certain actions to be undertaken by the management companies.

Article 39 Assessment, monitoring and review of risk management policy

13. The obligation: Article 39(2): management companies shall notify to competent authorities of their home Member State any material changes to the risk management process.

This information obligation will be quantified. For the consideration of administrative costs (AC)/administrative burden (AB) of obligation 13 the following data are used and the following assumptions are made:

The obligation required by the article 39(2) has its origin in the Level 1 Directive, Article 51(1).

It is an important obligation as it mirrors the new requirements put forward by level 2 article 39(3) stating that: "competent authorities shall review the management company's risk management systems and processes when granting authorisation and on an on-going basis."

Events that could trigger a change in company's risk management systems can be the following:

(i) management company decides to change the overall risk profile of the funds it manages (this can be as a result of including new asset classes into the portfolio mix of its funds that bring new risks that ultimately leads to defining and designing new/adjusting the existing risk management policy – e.g. fund merger can potentially have this effect) or

(ii) management company decides to change or adjust calculation methodologies using to determine in particular the global exposure of particular funds it manages

- number of entities concerned:

In the impact assessment on the recast of the UCITS Directive, a number of domestic mergers were provided for the whole of the EU. In 2006, there were about 600 mergers of UCITS within the EU Member States.

For the purposes of this calculation we can estimate that one third of them (200) could imply material changes to risk management systems for UCITS companies and as such could serve as a proxy for estimating the number of events concerned.

- frequency of reporting:

It is not a one-off event but could happen on an ongoing basis. To simplify it and to align the assumption with the example of mergers, it can be assumed that such occurrence will not happen more than once in a year to a particular company.

- required actions:

There would be in principle two distinct actions concerned: (i) the first one relates to the design and adjustment of the risk management policy itself, which is an internal action undertaken by most likely the risk management function and (i) the second one relates to the dispatching of this information to relevant authorities.

Resulting administrative costs calculated in this regard are around EUR 240.000, all of it is to be considered as administrative burden originating from EU legislation

10.2. COMMISSION REGULATION (EU) No …/.. implementing Directive 2009/65/EC of the European Parliament and of the Council as regards the key investor information and conditions to be met when providing the key investor information or the prospectus in a durable medium other than paper or by means of the website.

This regulation does not contain any requirements or obligations that would be relevant for the consideration in respect of administrative costs/administrative burden stemming directly from the requirements of level 2 legislation.

However, recently conducted study on the cost and benefits of the Key Investor Information provides an indication of the impact of the changes at level 1 of the

UCITS Directive – to replace the simplified prospectus with a standardised and harmonised format and way how pre-contractual information is to be provided to prospective investors.

The key findings with respect to quantifiable costs to be borne by the industry as a result of the changes at level 1 can be found in Annex I, section 3.1.

10.3. COMMISSION DIRECTIVE ../…/EC on implementing Directive 2009/65/EC of the European Parliament and of the Council as regards certain provisions concerning fund mergers, master-feeder structures and notification procedure

Article 7 Method of providing the information to unit-holders

1. 14. The obligation: Member States shall ensure that the merging and the receiving UCITS provide the information pursuant to Article 43(1) of Directive 2009/65/EC to unit-holders on paper or on another durable medium.

Article 29 Manner of providing the information to unit-holders

2. 15. The obligation: Member States shall ensure that the feeder UCITS provides the information to unit-holders pursuant to Article 64(1) of Directive 2009/65/EC on paper or on another durable medium.

These information obligations will be quantified. For the calculation of administrative costs (AC)/administrative burden (AB) the following data are used and the following assumptions are made

- number of entities concerned:

Article 7: The impact analysis of the Level 1 changes to the UCITS Directive showed that in 2006 around 600 domestic mergers occurred. If we consider that about 500 mergers would occur on a cross-border basis that would concern around 1000 UCITS funds per year (2.7% of the whole UCITS fund population) and approximately 2 million of investors. The same assumption can be made for Article 29 as the requirement is identical it only refers to different manner of pooling funds assets. However, mapping of Member States regimes indicates that approximately 55% of UCITS investors are subjected already to an active/direct information provision. In this respect the appropriate reduction of the number of investors is relevant and results into 900 000 investors eligible for mergers and the same amount for master-feeder structures, 1.8 million in total.

Based on EFAMA statistics, some Member States (DK, DE, ES and SLO) report the number of unit-holders in all investment funds domiciled in their countries. Estimated number of UCITS unit-holders in these countries was calculated taking into account the proportion of UCITS funds to all investment funds in these countries. Based on these estimates, it was possible to calculate potential average number of unit-holders per UCITS fund in these countries. Taken together, the average number of UCITS investors per UCITS fund is approximately 2.000 investors.[129]

These estimates need to be considered with caution as the framework for cross-border mergers and master-feeder structures is new and the take up of these new possibilities will certainly be gradual and will most likely not reach the number of events that are currently being recorded for domestic mergers.

- frequency of providing the information to investors:

For both articles, it is expected that each time a merger or a master-feeder structure is going to happen, investors in the funds concerned by these two events should be notified. It is therefore to be considered as event occurring on an on-going basis.

- required actions:

The additional requirements that comes on top of level 1 requirements in this particular area are not linked to the preparation or drawing up of the information as such, these are indeed contained in the level 1 UCITS Directive.

The additional actions that are linked with additional administrative costs are those as presented by the articles 7 and 29 in which it is required that UCITS informs all investors in an active manner – via an e-mail or a letter – about a merger or master-feeder structure.

Cost of these actions can then be estimated as the cost of: (i) drawing up the information itself, (ii) preparing the paper version of the letters to all investors concerned that could take up to two days and (iii) paying for the stamps. The more expensive version of sending such information could then take up to two days to be prepared by the administration of the UCITS and its price.

For the purposes of calculating the administrative costs, action related to the drawing up of the information itself is not going to be considered as it is already being done by all management companies (business as usual). The associated additional costs stemming from these two requirements are then related to dispatching of the information to individual investors.

Resulting administrative costs calculated in this regard are around EUR 400 million, all of it is to be considered as administrative burden originating from EU legislation.

10.4. COMMISSION REGULATION (EU) No …/..implementing Directive 2009/65/EC of the European Parliament and of the Council as regards the form and content of standardised notification and attestation letters, the use of electronic communication between competent authorities for the purpose of notification, and procedures for on-the-spot verifications and investigations and the exchange of information between competent authorities

This regulation does not contain any requirements or obligations that would be relevant for the consideration in respect of administrative costs/administrative burden stemming directly from the requirements of level 2 legislation.

[129] See Annex II, section 9, table 9.2 for more details.

Table 10.1: Summary of administrative costs

(A) Commission Directive ../../EU Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirement s, conflicts of interest, condut of business, risk management and content of the agreeemnt between a depositary and a management company (MCP) (C) COMMISSION DIRECTIVE ../…/EC on implementing Directive 2009/65/EC of the European Parliament and of the Council as regards certain provisions concerning fund mergers, master-feeder structures and notification procedure (MERGERS and MASTER-FEEDER)						Tariff (€ per hour)		TIme (hour)		Price (per action or equip)	Fr (per
No.	Ass. Art.	Orig. Art.	Type of obligation	Description of required action(s)	Target group	i	e	i	e		
A	39§2	51§1	Notification of (specific) activities	Adjusting existing data	Investment fund sector - asset managers	30		40,00		1200,0	
A	39§2	51§1	Notification of (specific) activities	Submitting the information (sending it to the designated recipient)	Investment fund sector - asset managers	25		0,50		12,5	
C	7	43§1	Notification of (specific) activities	Submitting the information (sending it to the designated recipient)	Investment fund sector - asset managers	14		12,00		168,0	
C	7	43§1	Notification of (specific) activities	Submitting the information (sending it to the designated recipient)	Investment fund sector - asset managers	14		1,00		14,0	
C	29	64§1	Notification of (specific) activities	Submitting the information (sending it to the designated recipient)	Investment fund sector - asset managers	14		12,00		168,0	
C	29	64§1	Notification of (specific) activities	Submitting the information (sending it to the designated recipient)	Investment fund sector - asset managers	14		1,00		14,0	