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*Accompanying the*

**WHITE PAPER**

**WHITE PAPER ON ENHANCING THE SINGLE MARKET FRAMEWORK FOR  
INVESTMENT FUNDS**

**EXECUTIVE SUMMARY TO THE IMPACT ASSESSMENT**

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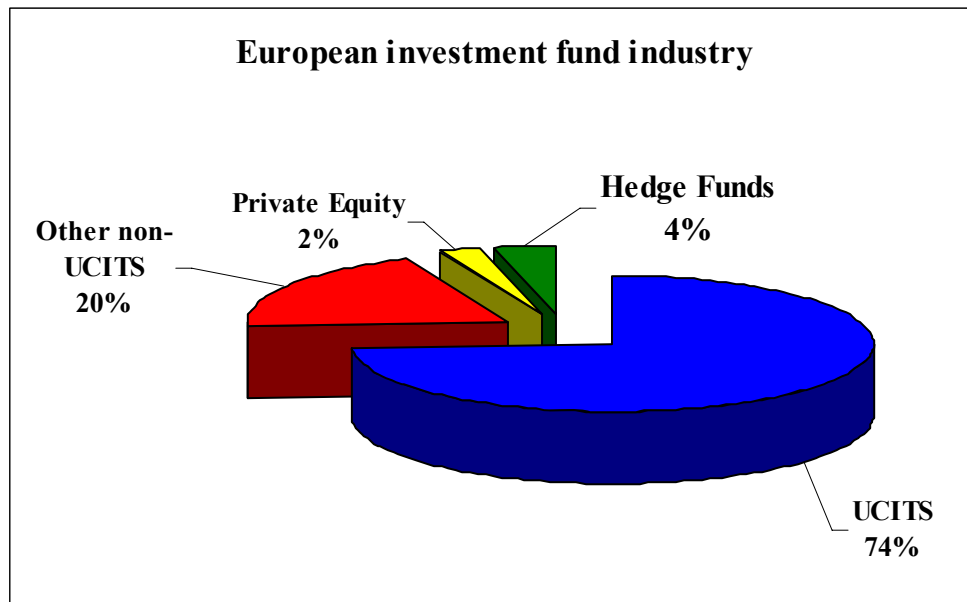
## The process

The Commission Green Paper on investment funds set in motion an extensive process of consultation on possible improvements to the UCITS framework. Numerous contributions from stakeholders have been received. In parallel to these contributions a number of work-streams have also provided valuable input to the impact assessment (IA). Two industry expert groups have advised respectively on the ways to improve the efficiency of the European retail fund market and on how to remove obstacle for the pan-European development of alternative investments. Two externally tendered studies have analysed current trends in the European fund industry and estimated the cost savings of a fully integrated fund market. Specially organised workshops have given investors, regulators and industry players the opportunity to debate avenues for improving the simplified prospectus. Finally, an inter-services IA Steering Group has guided the preparation of this report.

The IA report analysis has been instrumental in defining Commission strategy in the fund area for the coming years. This strategy is presented in the White Paper on investment funds. The centrepiece of the White Paper is a proposal for legislative amendments to be tabled in autumn 2007. An in-depth analysis of the impacts of the concrete legislative actions will complete this report's analysis. It will be published in parallel to the legislative proposal.

## Context

Since the adoption of the UCITS Directive 20 years ago the European fund market has become larger and deeper. The number of funds has increased continuously. At the end of 2005, there were more than 29,000 UCITS. Assets under management have also rapidly expanded, reaching the bar of € 5 tr. In 2005, total EU investment fund assets corresponded to 59% of the Community GDP. UCITS funds represent about 75% of all investment funds in the EU.



The number of UCITS offered across borders has doubled since 1998. Today, nearly 5,000 funds (or 17% of the total) are cross-border. This trend is set to continue: net sales of cross-border funds have systematically exceeded those of domestic ones in the recent past.

The UCITS model is considered as a 'gold-standard' both inside and outside the EU. UCITS funds have acquired large market share in third-country markets. This global acceptance of UCITS is due to the safeguards built into the Directive itself and the absence of significant scandals.

Despite this positive background, a rapidly changing environment is testing the robustness of the UCITS framework. The fund industry is facing important challenges.

- Financial innovation. Innovation will inevitably overtake prescriptive rules on investment policy. If the UCITS framework does not keep pace with market developments, asset managers will package investment propositions in more flexible regulatory formats.
- Growth of non-harmonised funds. There has been a strong growth of non-UCITS products in recent years. Some of these products are available to retail investors at national level in a number of Member State markets. There is growing frustration from some product providers in some of these segments that they are denied the opportunity to serve a pan-European investor base.
- Global competition. UCITS authorisation is widely perceived as a guarantee of sound product structuring and effective regulation. Thus, it has gained the trust of regulators in many third countries. However, competition from other fund jurisdictions is starting to build. To continue to attract custom around the world, it will be necessary to eliminate unnecessary cost and support innovation.
- Growing need for private retirement products. European societies are ageing. Effective private solutions will be important to complement state and occupational pensions. Investment funds provide an established vehicle for accumulating capital throughout working life.

### Identified problems

The UCITS framework is gradually coming under strain. The Green Paper consultation revealed that there is little disagreement regarding the sources of failure in the European fund market. On the supply side, the main problems are:

- Proliferation of funds of a sub-optimal size. 54 % of European funds manage less than € 50 million in assets. This impedes the exploitation of economies of scale and increases costs. The Total Expenses Ratio of a typical cross-border European equity fund is double than that of an American fund. Fund proliferation is set to continue. In 2005, the total number of funds increased by 887 in Europe while the US market witnessed a reduction of 65.
- Lack of flexibility in organising the industry value-chain: The UCITS Directive restricts the ability of the fund manager/fund as to the location of key core functions. The UCITS Directive requires that the depositary is based in the same country as the fund. Also the possibility for the management company to offer its services across borders is restricted in practice. This not only limits the capacity of the industry to achieve economies of scale and specialisation, but also leads to a duplication of resources that raises costs. Between € 381 and € 762 million could

be then saved annually if each European managing group could carry out its activities through a single management company.

- Delays in getting products into the market: UCITS Authorisation (by the Home Member State) and Notification (to the Host Member State) procedures are often long and cumbersome. While the direct costs are limited, uncertainty as regards the duration of the procedure can have an important impact on business opportunities. Both uncertainty and long delays seriously handicap the fund industry in competing with other investment products (e.g. unit-linked insurance contracts, certificates...)
- Strict investment restrictions: The definition of the product imposed by the Directive is perceived as reducing investment and business opportunities for both investors and industry. The problem is compounded by the fact that UCITS compete with other products with similar characteristics but subject to different forms of disclosure and intermediary regulation. There is the risk that investment propositions would be repackaged in more convenient regulatory forms offering lower levels of investor protection.
- Non-standardised fund order processing: The treatment of a subscription or redemption order implies a series of interactions between different actors and varied (often manual) steps. The lack of automation and standardisation increases costs and delays and can exacerbate operational risks.

On the demand side, the problems stem from:

- An ineffective simplified prospectus. It is too long and complex and, thus of limited value to the investors. It also entails considerable cost overhead for the fund industry.
- High level of costs at the distributor's end. Limited competition and openness have led to sizeable distribution costs. These can amount up to 75% of total costs in some Member States. Distribution networks are gradually more complex and the number of intermediaries is increasing. This may exacerbate concerns about the loss of transparency and higher costs.

#### Available solutions

In order to provide relief from these problems, Commission services have analysed a number of options for their implementation. These have been compared against the status quo or 'do nothing' baseline.

##### (1) Exploiting economies of scale

It has been estimated that the European fund industry could save between € 2 to 6 billion annually if it was able to reap untapped economies of scale. Two avenues for achieving this goal have been analysed: (cross-border) fund mergers and asset pooling.

In the case of mergers, an enabling EU-level framework would produce static efficiency gains and non-negligible longer-term effects, such as greater competition among players and enhanced industry competitiveness. To be effective, this framework should adequately deal

with two types of obstacles: the merger mechanism itself and the adverse tax implications that the merger may generate. As regards the method, non-legislative options risk being ineffective. Only a change to the Directive would make possible potential savings while preserving investor protection. Concerning tax implications, the adoption of a taxation Directive seems fraught. Non-legislative options including a Communication based on recent jurisprudence could be a more effective way of limiting adverse tax implications.

The analysis of 'asset pooling' distinguishes between two sorts of pooling techniques: entity pooling and virtual pooling. Again, opportunity costs suggest compelling reasons to justify action. In the case of entity pooling, a Directive amendment cannot be avoided. UCITS diversification requirements are incompatible with this pooling technique. As regards virtual pooling, further work will be needed during the preparatory phase to develop provisions which support pooling and respond to supervisory concerns. The Commission will come forward with legislative proposals to provide a harmonised legally secure framework for the operation and supervision of virtual asset pools.

## (2) Improving organisational flexibility.

Two avenues have been explored: the management company passport and the depositary passport. The management company passport, foreseen by 2001 amendments to the Directive, has not proved effective. Ambiguous drafting of relevant provisions is one of the main reasons. Also there are concerns about managing the split between regulators of the supervision of the fund and of the management company. CESR guidelines to streamline cooperation mechanisms already built into the Directive could alleviate these concerns. However, their non-binding nature may compromise their effectiveness. A change to the Directive would also be needed to clarify ambiguities in the existing text.

The appropriateness of introducing a passport for the depositary has been largely debated. The prevailing view is that such a passport would not make sense without the prior harmonisation of the role and responsibilities of the depositary. However, the scope of the anticipated gains does not seem to justify the regulatory and commercial disruption that the corresponding amendment to the Directive would require. Other solutions to enhance the flexibility in the depositary market appear to be more cost-effective. Two are analysed in the report: allowing branches from banks authorised in another Member State to act as depositaries and allowing depositaries to delegate the safe-keeping of assets to a custodian in another Member State. These will require changes to national legislation in some Member States. In the longer-term, Commission services will continue their monitoring of the depositary market in order to assess the necessity for greater flexibility and/or harmonisation.

## (3) Reducing time-to-market.

Proposals to improve the delays to market of UCITS have been made at two levels. First, at the level of the authorisation by this home Member State authority. Second, at the level of its notification to the host Member State authority.

Regarding the authorisation procedure, the analysis recognises that the absence in the Directive of a fixed maximum period results in very varied delays depending on the Member State. However, a reduction in authorisation times is already perceptible due to the competition among national authorities. Intervention of the EU regulator appears not to be cost-effective or justified on 'subsidiarity' grounds.

Concerning the notification procedure, the IA confirms that official authorisation provides comfort that the product being sold to retail investors has been reviewed and is acceptable. Non-legislative efforts to expedite notification have been attempted. Unfortunately, these improvements cannot solve all identified problems, namely the long delays and uncertainty flowing from the Directive. Modification of the relevant Directive provisions is the only effective way to deliver the desired simplification and efficiency gains.

(4) Exploiting new investment possibilities.

A Directive change is needed in order to give managers access to larger investment opportunities. However, the UCITS investment rules cannot be stretched indefinitely without losing credibility as high investor protection product. Nor are there compelling reasons justifying an immediate change to the Directive. Further analysis would be needed to thoroughly assess the use of investment powers by UCITS and non-UCITS (particularly those accessible to retail investors in some Member States) and to identify potential related risks. This could be a valuable basis to decide on the need for any medium-term review of the regulatory architecture.

(5) Promoting the standardisation of fund order processing.

Industry-led initiatives exist in this area. The IA has looked at the appropriateness of completing or supporting those with public sector measures. However, the identified inefficiencies are not of a legislative or regulatory nature. The openings for public sector involvement are therefore not obvious.

(6) Streamlining the simplified prospectus

Analyses and consultations revealed that market players and regulators do not regard the concept of simplified prospectus itself as flawed. However, the way in which it has been implemented has undermined its effectiveness. Abolishing the simplified prospectus would deprive investors of useful disclosures. Nor does 'Doing nothing' seem to be an acceptable option from a consumer protection point of view. To enhance the simplified prospectus a long list of issues (e.g. its nature, scope and design) would need to be addressed. Soft-law avenues could be pursued; but they will not solve all the identified drawbacks of the simplified prospectus. Also their effectiveness appears limited. A change of the Directive seems to be necessary. This should be accompanied and prepared by other shorter term non-legislative measures.

(7) Preserving high levels of investor protection in fund distribution

Distribution systems must deliver solutions that meet the needs of individual investors. Conflicts of interest and inducements must be properly managed or disclosed. The Markets in Financial Instruments Directive (MiFID) provides the tools to manage these concerns and to underpin the quality of client support that intermediaries provide to investors. Monitoring the implementation and effectiveness of MiFID on the distribution of UCITS will ensure that any problems could be addressed immediately.

(8) Facilitating pan-European distribution of non-harmonised funds

Fund markets are developing rapidly and Commission services would need to closely monitor their evolution in order to prevent potential single market barriers and investor protection

risks. However, extending the UCITS passport to non-harmonised funds does not appear to be justified at this stage. The potential costs and benefits of doing so, as well as the possible options remain unknown. A common private placement regime, on the other hand, will allow non-harmonised fund managers to deal directly with qualifying investors and eligible counterparties across the EU and, thus, to expand their business without giving rise to investor protection concerns.

#### Retained options

The IA reveals that a series of measures will be needed to overcome identified problems. Many of them will require changes to the UCITS Directive.

<b>Measure</b>	<b>Required action</b>
Creation of an EU framework for fund mergers	Directive change
Interpretative Communication on the taxation of cross-border fund mergers	non legislative
Creation of an EU framework for entity and virtual pooling	Directive change
Activation of the management company passport	Directive change
Greater flexibility for the pan-European organisation of custody services	legislative change at national level
Launch a review of the use of investment powers by UCITS and non-UCITS	non legislative
Simplification of the notification procedure	Directive change
Streamlining of the simplified prospectus	Directive change + non-legislative
Monitoring of MiFID implementation and its impact on UCITS distribution	non legislative
Assess the appropriateness for non-harmonised funds of developing a private placement regime for qualified investors	non legislative

#### The analysis of the impacts of the chosen options

##### (a) for industry players

The time, costs and uncertainty associated with the management of UCITS will be materially reduced. Industry players will be also able to better organise their business on a pan-European level. They will, thus, be able to achieve economies of scale and specialisation. Implementation of the retained options will also produce dynamic effects. It would increase market integration and thus competition, which should further push costs down. At the global level, cost savings would increase the competitiveness of the European fund industry.

##### (b) for investors

Rationalisation of complex fund ranges, reduction of costs and more user-friendly disclosure documents will have direct implications for investors. This will lead in the longer term to an improved choice and better performing products. Some sources of cost savings will accrue directly to the fund and its unitholders. High levels of investment protection will be secured by introducing new requirements or strengthening and clarifying existing provisions. Investors will be also better armed to take informed decisions and their interests will be more difficultly disregarded.

(c) for regulators

Implementation of Directive modifications will lead to a reorganisation of the functions and actors of the industry's value-chain. Different enforcement authorities may be responsible for closely related functions. This will require effective cooperation between the relevant authorities. There will be a need to clarify authorities' respective roles and responsibilities and, thus, address split supervision concerns. However, the required efforts on part of regulatory authorities are considered to be outweighed by the long-term positive effects that the changes to the legislative framework will entail for other stakeholders.