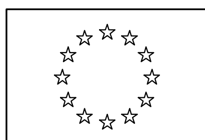

COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMISSION STAFF WORKING DOCUMENT

Accompanying the

WHITE PAPER

WHITE PAPER ON ENHANCING THE SINGLE MARKET FRAMEWORK FOR INVESTMENT FUNDS

IMPACT ASSESSMENT

{COM(2006) 686 final}
{SEC(2006) 1452}

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.

Lead DG: Internal Market and Services

Other involved services: Competition, Economic and financial affairs, Enterprise and industry, Health and Consumer Protection, Taxation and Customs Union, Secretariat General

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Executive Summary

This impact assessment report summarises the process that led to the decision by the Commission to present a White Paper on Investment Funds. The decision making was heavily based on extensive consultation of stakeholders, review of existing literature and data as well as the exploitation of studies that had explicitly been launched to this aim.

This in-depth analysis mainly confirmed the evaluation of the situation that had been presented in the Green Paper in July 2005. The current legislative framework does not allow stakeholders to efficiently and effectively exploit the Single Market freedoms granted by the UCITS Directive. In some areas additional Single Market freedoms need to be granted to ensure that the industry can get organised across borders in the most efficient way. Furthermore, the non-harmonised part of the fund industry is currently deprived of a pan-European basis for its business.

While problems had been identified in various issues covered by the Directive it was confirmed that there was no clear case for abandon the current product approach at this stage. Though, addressing some of the most pressing problems would nevertheless require amendments to the Directive in the very near future. This concerns the notification procedure, fund mergers, asset pooling, the management company passport, and the simplified prospectus. The respective amendments should also have a positive effect on future law-making and supervision as the amendments introduce more efficient procedures through the implementation of the Lamfalussy process in these areas and clear guidance for regulators and supervisors.

In other areas the impact assessment came to the conclusion that no legislative change would be required at this stage. In some cases the Commission will further monitor the situation and might propose action at EU level at a later stage if needed. This concerns the protection of investors' rights in the distribution process, the delineation between UCITS funds and non-harmonised funds, and the establishment of a pan-European private placement regime.

Finally, the impact assessment came to the conclusion that there is no need for immediate action at European level as regards the authorisation procedure for funds, the fund order processing, and the introduction of a depositary passport.

Introduction

Procedural issues and consultation of interested parties

- *Chronology*

The preparatory process for the proposal started with the preparation of the Green Paper in July 2005. The Commission then organised a series of inputs to support the Commission's thought process. Inputs ranged from bilateral informal meetings with stakeholders to studies, expert groups, hearings and workshops. Many of these events brought together different players in order to immediately confront the proposals from one side of the market with those of the others. As most of these exercises have been open and have been documented on the Commission's website it was a very transparent process. This has been highlighted and acknowledged frequently by stakeholders.

Table 1 Chronology of the preparatory process

Date	Item
2004	
May	FSAP Expert Group on Asset Management Report
2005	
14th July	Green Paper on the enhancement of the framework for investment funds
Sept.	White Paper Roadmap
13th Oct.	Open Hearing on the Green Paper
21st Oct.	Start of "Potential Cost Savings" study
15th Nov.	End of the Green Paper's consultation period
21st Dec.	Start of "Current trends" study
2006	
31st Jan.	Establishment of two Expert Groups
8th March	1st meeting of the Inter-service Impact Assessment Steering Group
15th May	1st Workshop on the Simplified Prospectus
19th May	2nd meeting of the Steering Group
4th July	Final reports of the Expert Groups published
11th July	2nd Workshop on the Simplified Prospectus
18th July	3rd meeting of the Steering Group
19th July	Open Hearing on the Expert Groups' reports
Aug./Sept.	Final report studies
8th Sept.	4th meeting of the Steering Group
Sept.	Draft impact assessment report

- *Consultations*

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

of which one was dedicated to asset management. This group's report, published in 2004[1], identified a list of issues requiring action. These were:

- simplification of the notification procedure
- facilitation of cross-border fund mergers
- recognition of pooling structures and techniques
- an effective single passport for management companies
- greater freedom of choice of depositaries
- facilitation of the operation and administration of funds
- rapid reaction to tax discrimination
- greater transparency in fund distribution
- development of indicators to monitor competition and integration
- improve corporate governance and enhance investor education

Reponses to the open consultation that followed broadly supported the report's main conclusions. There was a widespread consensus that there was considerable room for improvement in the EU legislative framework regulating asset management along the lines pointed out by the experts. Nevertheless, respondents diverged in the relative order of priority for tackling them.

Subsequent discussions with Member States, CESR members and market participants confirmed the need to make the corresponding legislation function better. The Commission Green Paper on investment funds[2] of July 2005 identified concrete steps in this direction. The Green Paper proposed a series of actions in the short term and launched a debate on the need for a more wholesale reform of the investment funds legislative framework in the medium to long-term.

Views expressed during the Open Hearing on the Green Paper (October 2005) and during the open consultation (mid-July to mid-November 2005) widely agreed with the Green Paper's approach for the short term, that is, improving the implementation of the provisions of the existing framework. The simplification of the notification procedure and streamlining the simplified prospectus were considered as top priorities. There was also a willingness to look beyond current legislative provisions towards proposals such as expanding the range of single market freedoms available to fund managers. There was a large degree of support among respondents for examining some of these options - management company passport, master-feeder pooling structures, and cross-border fund mergers[3]. There was a wide spread of opinions on whether the current product-based approach represented a sustainable approach

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

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

[3] A summary of the conclusions of the Open Hearing can be found at: http://europa.eu.int/comm/internal_market/securities/ucits/index_en.htm#hearing. The Feedback Statement on the Green Paper consultation can be found at: http://europa.eu.int/comm/internal_market/securities/docs/ucits/greenpaper/feedback_statement_en.pdf The individual responses can be found at: http://forum.europa.eu.int/Public/irc/markt/markt_consultations/library?l=/financial_services/asset_management&vm=detailed&sb=Title

for regulating investment funds in the long term. Responses revealed some, though not unanimous, support for an eventual move towards principle-based regulation, counter-balanced by concerns that a fundamental overhaul of existing single market rules could give rise to unintended consequences and disruption, as well as postpone urgently needed changes.

The European Parliament has also contributed to the debate with an own-initiative report adopted in April 2006[4]. The report main conclusions are that:

– there is no need for a complete make-over of UCITS Directive; [5]

– it is however necessary to make the UCITS Directive evolve in line with changes in the market through a combination of better implementation of existing Directive and targeted adjustments or additions to the existing Directive;

– any legislative adjustments to the Directive should integrate the possibility for adoption of detailed implementing legislation via comitology (Lamfalussy procedure).

Two workshops on the simplified prospectus took place 15th May and 11th July 2006. The main conclusions were that the simplified prospectus should:

– be addressed to retail investors

– be a short document in the form of "fact sheet"; a maximum length should be imposed

– provide key information to the retail investor, enabling it to make an informed investment decision

– be available in the national language(s)

Furthermore, once filed with the home state regulator, no further additions should be required by the host state regulator. The fund promoter should be responsible for all product related disclosures and the distributor for any other disclosures. There was agreement on the need for thorough consumer testing of a revised Simplified Prospectus.

- *Expertise*

Studies: In order to complement internal research and the public consultation with empirical data, two studies were launched in 2005.

– The "Current trends in the European Asset Management industry" study aimed at providing historical series of asset management related data relevant to understand the functioning of the industry and how it has been evolving over the years. It also conducted an analysis of the trends having an impact on the integration of markets and on the risk-features in European asset management. The study has been conducted by ZEW/OEE and Oxera.

– The "Potential cost savings in a fully integrated European investment fund market" study aimed to present a detailed comparative description of the main

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

[5] Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as amended in 2001; frequently referred to as "the Directive" in the following.

sources of cost in the EU investment fund value-chain. The consultant (CRA) was also mandated to identify and quantify potential sources of cost savings that could be achieved by enhanced market integration.

Expert Groups:

- Independent expert group on the review of the FSAP (Asset management) in 2004[6]
- Two expert groups to further explore the need and form of possible measures with regard to market efficiency and alternative investments (namely private equity and hedge funds). These groups consisting of industry experts have been established in February 2006 and produced final reports in July 2006.

The latter reports have been published on the Commission website[7]. The general public was invited to discuss the reports at the occasion of an open hearing which took place 19th July[8] in Brussels or in writing during the following two months.

The hearing showed that the industry's views on efficiency issues are very much in line with the views the Committee on Economic and Monetary Affairs of the European Parliament has expressed in its report on asset management in March 2006.[9]

Committee of European Securities Regulators (CESR):

CESR has accompanied and supported the Commission's efforts to improve the legislative framework for undertakings for collective investment in transferable securities (UCITS) with various consultations and advice on different subjects as well as with fruitful discussions and contributions. Concretely, during the last months CESR has provided the Commission with advice on UCITS eligible assets and adopted guidelines on the transitional provisions of the new UCITS III regime and the notification procedure. The work on eligible assets has been generally welcomed by market players. It will be translated into implementing measures, hopefully to be adopted in January 2007. The notification guidelines, however, are restricted by the Directive itself and are thus not capable of solving the problems resulting from its drafting.

IA Steering Group

A steering group was established in February 2006. It advised the service responsible on both the substance, but especially structuring of this report. Colleagues from Directorates General Competition, Economic and Financial Affairs, Enterprise and Industry, Health and Consumer Protection, Internal Market and Services, Taxation and Customs Union, and the Secretariat General participated in the discussions. The Group met four times ahead of the finalisation of this report.

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6 http://ec.europa.eu/internal_market/finances/docs/actionplan/stocktaking/report-assetmgnt_en.pdf

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

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

9 http://www.europarl.europa.eu/omk/sipade3?PUBREF=-//EP//NONSGML+REPORT+A6-2006-0106+0+DOC+PDF+V0//EN&L=EN&LEVEL=0&NAV=S&LSTDOC=Y

Financial Services Consumer Group + FIN-USE

The Green Paper and the Commission's preparatory work have been presented in the first meeting of the Financial Services Consumer Group on 20th June 2006.[10] Members of the group have been invited to provide the Commission with their views. The White Paper and this report will also be presented to the group in its next meeting in December 2006.

Commission services have also actively sought the input of FIN-USE, the Forum of user experts in the area of financial services. Two meetings have taken place (December 2005 and June 2006) in order to present to experts the developments in the asset management area and encourage their contribution to the expert groups' reports' debate.

- *How external input from consultations, expert groups and studies has been used*

The *industry group on market efficiency* has issued advice on how to tackle the bottle-necks that are holding back the efficient reorganisation of the business. These issues included:

- A no holds barred rethink of the UCITS notification procedure
- Ways to remove legal, tax and other obstacles to cross-border fund mergers
- Removing regulatory resistance and legal barriers to different types of pooling
- Allowing fund managers to manage funds domiciled in other jurisdictions
- Pragmatic steps to increase access to competitive custodian services

These recommendations have been carefully analysed - in the light of other stakeholder reactions received at the open hearing and written contributions on the report.

The *reports on alternative investments* (i.e. hedge funds and private equity) – including the feed-back received -, and the study reports have also been carefully considered in the preparation of this report and helped substantiating the analysis. References to the various sources can be found in the following and especially in the detailed analyses of the individual issues.

One major aim in launching the studies has been to gather as much independent expertise and "hard" evidence as possible. Unfortunately, the data gathered was not sufficient in terms of quantity and quality to allow for quantification of the costs and benefits of different options. This, however, was due to the fact that comparable and detailed data does not exist.

Nevertheless, both studies contributed to the Commission's understanding of the structure, problems and trends of the industry and helped shaping both this report and the White Paper.

CONTEXT

This impact assessment is not discussing action in a new area but changing or replacing an existing Directive. Therefore, this section provides some background information on both the "legislative history" and the economic development of the industry in the EU. Some most the

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

problems, which are discussed in more detail in the next section, will already be put in context here.

The 1985 Directive and the amendments in 2001

On 20th December 1985, the Council adopted the Directive on the coordination of laws, regulations and administrative provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS) 85/611/EEC. The Directive had two main objectives:

To foster gains for all market participants through greater integration: The Directive set the basis for the free marketing of investment funds in the Community. To this aim, it introduced the UCITS passport, allowing an UCITS authorised by a Member State to be marketed in another Member State on the basis of a simple notification. The creation of a market without internal borders for investment funds should then bring benefits for all market players. It should enlarge the choice available for investors, create new opportunities for fund promoters, and enhance competition, which would in turn push down costs and fees, leading to higher net returns for the end investor.

To ensure an adequate level of investor protection: The investor protection provisions built into the Directive were motivated by the existence of one of the most frequent market failures in financial services: information asymmetry. Though, there are of course also other risks to be taken into account like, e.g., fraud or loss of assets. The protection of investors was to be ensured by three reinforcing pillars: a set of investment rules aiming to make UCITS a transparent, diversified and liquid vehicle (e.g. by determining the assets in which an UCITS could invest or by imposing portfolio diversification rules); disclosure requirements ensuring regular information to investors; and an independent depositary, which would be in charge of the custody of the assets and of the oversight of the fund and its management company.

Like other pieces of financial services legislation, the UCITS Directive has gradually been superseded. In 2001, two amending directives[11] were adopted in order to modernise UCITS law. These Directives were an important step to enhance the flexibility of the UCITS framework. They broadened the range of UCITS' eligible assets and introduced the concept of a management company passport. However, this greater flexibility was coupled with new provisions aiming to maintain the level of investor protection. Low capital requirements and the need to introduce adequate risk management controls were imposed on the management company. The simplified prospectus was created as a marketing tool that would provide the fund key information to investors and that would allow for a comparison between funds.

It is important to note that the Directive does not cover all types of collective investment schemes (CIS). CIS might remain outside UCITS for very different reasons. For instance, the funds might make use of investment possibilities that are prohibited for UCITS or might not comply with UCITS rules regarding redeemability, valuation, etc.

Furthermore, despite the introduction of some "Lamfalussy" elements with the 2001 amendments, the UCITS Directive as a whole is not a so-called Lamfalussy Directive. In particular, it does not take the form of principle-based legislation where key concepts and obligations in the framework directive are given more concrete and detailed expression

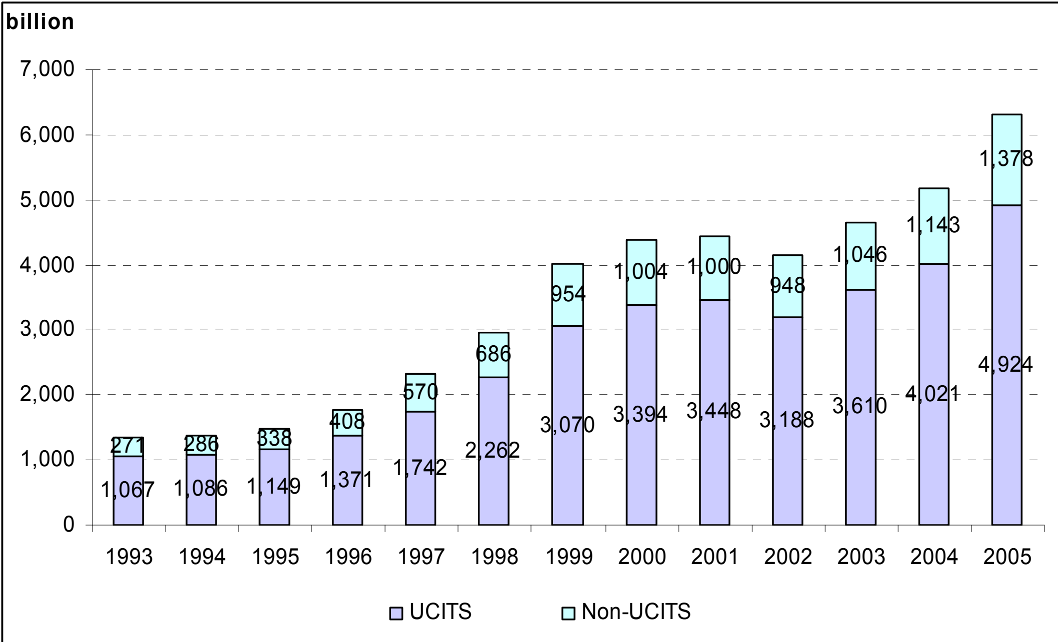
[11] Directives 2001/107/EC ("Management Company Directive") of 21 January 2002 and 2001/108/EC ("Product Directive") of 21 January 2002 both referred to in the text as UCITS III.

through implementing legislation (adopted via comitology procedures). For details on the Lamfalussy approach to legislation see Annex.

The investment fund industry in the EU

Some 20 years after the adoption of the Directive, the UCITS model is in many respects a success. The European market for investment funds has become larger and deeper over the last years. The number of funds has continuously increased. At the end of 2005, there were more than 29,000 UCITS. Assets under management (AuM) have also rapidly expanded; they reached the bar of € 5 trillion at the same date[12]. UCITS funds represent about 80% of all harmonised and non-harmonised investment funds in the EU.[13]

Figure 1: Net Assets of European Investment Funds (EUR billion)



Source: European Commission (2006), based on ZEW/OEE database, data from EFAMA on all EU-15 countries, Czech Republic, Hungary, Poland, and Slovakia

UCITS funds are not only being sold within the EU.[14] The UCITS regulatory concept has become a de facto international gold standard. As such, UCITS authorisation has often been sufficient to allow EU fund managers easier access to third-country markets, not only in Europe (i.a. Switzerland and Norway) but also in Asia and Latin America (i.a. Chile, Peru, Hong Kong, Taiwan). The absence of major financial scandals involving UCITS and the perception of UCITS as a well regulated product, have contributed to this success.

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12 EFAMA end of 2005 data

13 For more information on the EU investment fund industry please see the Financial Integration Monitor FIM 2006 on which this section is based; http://ec.europa.eu/internal_market/finances/fim/index_en.htm.

14 No reliable data is available about this third-country business.

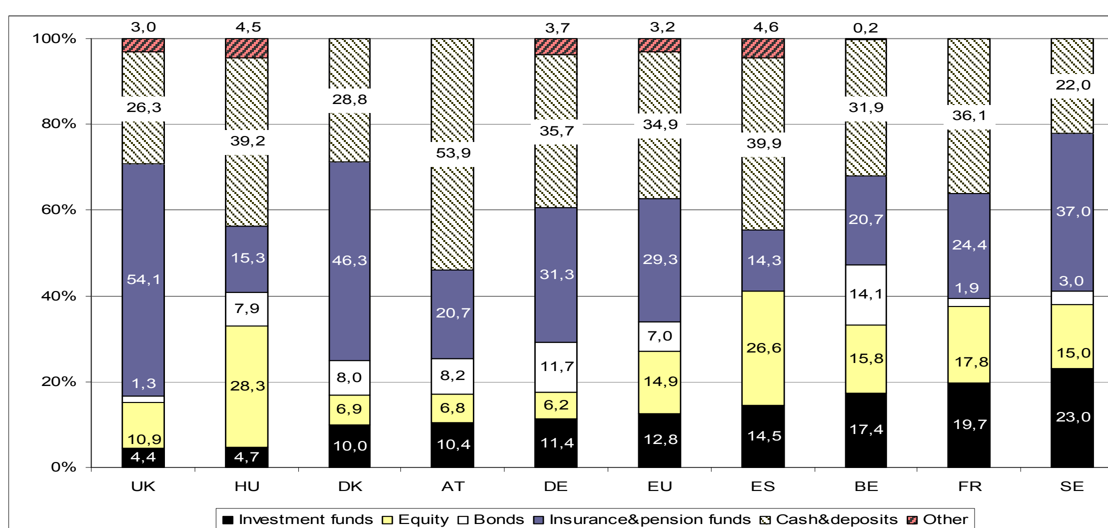
The fund industry as part of today's economy

In 2005, the total EU investment fund assets corresponded to 59% of the Community GDP (50% in 2004; 49% in 2000; 21% in 1995)[15]. Apart from Luxembourg and Ireland, this ratio was above the EU average in France and Austria. In the other Member States it fell between about 20% and 40% percent, with the exception of Greece (16%) and Denmark (51%) as well as Poland, Slovakia, Czech Republic and Hungary, where it did not exceed 10%.

Saving in investment funds is one of the many options for households to allocate their assets. Although banking deposits and insurance reserves dominate household savings in most European countries, funds play an important role today. Their average share in the EU household assets amounts to nearly 13%, varying from 4,4% in the United Kingdom to 23% in Sweden.

For the last ten years, investment funds on average have been growing faster than the banking sector and the capital market as a whole. The strong growth might partly be due to the increasing need to provide own funds for retirement.

Figure 2: Household asset allocation in the EU in 2004 (in % of total)



Source: EFAMA Fact Book 2005

Cross-border business

Within the European Union, funds marketed on a cross-border basis play an increasingly important role in this industry. The UCITS passport paved the way for extensive cross-border marketing of funds. Nearly 5,000 UCITS (or 17% of the total) are widely sold cross-border, an increase of 50% over the past three years. This trend is expected to continue, as net sales of cross-border funds have outpaced sales of domestic funds over the past few years.[16] This is in large part explained by the fact that the passport is extensively being used for so-called round-trip funds; that is funds domiciled in one Member State and sold only back into one Member State which is the country of the sponsoring institution/fund parent. It is, however, felt that

[15] For EU-15 plus Czech Republic, Hungary, Poland, Slovak Republic.

[16] PwC and Lipper "Pan-European UCITS Distribution 2005"; end 2004 data. These figures refer to "true cross-border" funds, i.e. funds that are distributed in at least three Member States.

growth of cross-border business is considerably hindered by some of the requirements of the Directive and the way it is implemented by Member States.

Data on fund sales in the EU suggest a high level of cross-border distribution. Sales of funds domiciled in Luxembourg (236 bn euro) and Dublin (45 bn euro) accounted for about two thirds of total sales in the EU in 2005. Given the fact that almost all Luxembourg and Dublin domiciled funds are sold abroad, the combined volume (281 bn euro) can be considered as a good proxy for the volume of cross-border sales in the EU.

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

In contrast to the impressive cross-border business in products, i.e. funds, cross-border delivery of services and the degree of cross border consolidation of investment funds is rather low. While there were, for example, about 650 domestic mergers on average per annum in the period 2002-2005, it was less than 30 cross-border mergers.[17]

Market structure

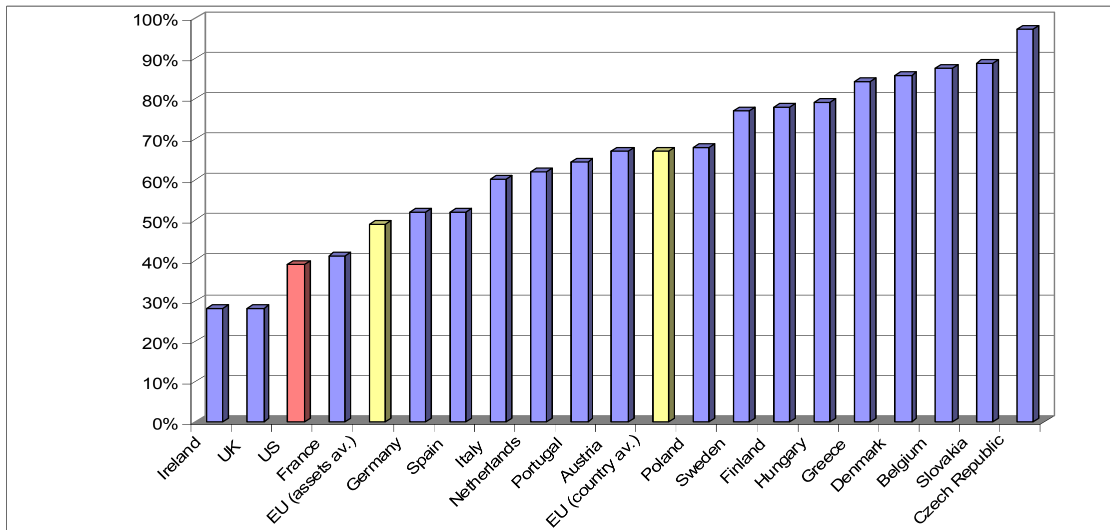
In the EU, measured by assets under management concentration of asset management companies tends to be lower in the biggest fund markets and higher in smaller markets. In 2004 the market share of top five asset managers was below 30% in Ireland and the UK, while in smaller Member States, such as Greece, Belgium or Czech Republic, it accounted for more than 80%.

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

The scarcity of true pan-European funds disables conclusive comparisons of concentration levels between the EU (as one entity) and the US (just below 40%), based on CR-5 indicator, the combined market share of the five biggest asset managers.

[17] FERI FundFile

Figure 3: Market share of top-5 asset managers (2004)



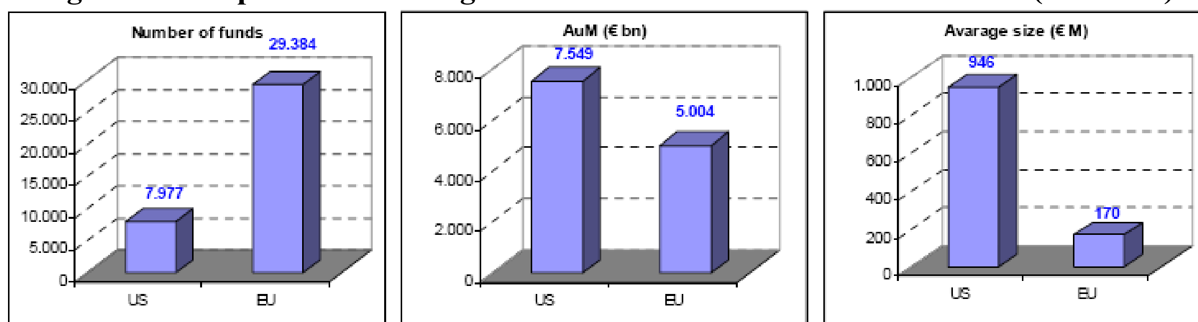
Source: EFAMA

Note: For the EU home and foreign domiciled funds, with exception of Ireland, United Kingdom, France, Spain, Netherlands, Austria, Poland, Finland, for which only home domiciled funds; EU assets av. – average weighted by assets (cumulated assets of top-5 managers in all the countries by total assets in the EU), EU country av. – simple average (by number of countries).

While assets of the fund industry in the EU and the US have been growing at a similar pace over the last decade, the number of funds in Europe has been increasing much faster: the number of UCITS in Europe doubled, while the number of the US funds grew just by a half.[18]

The graphs below show that in 2004 the total number of funds in Europe was more than three times higher than in the US. At the same time, total assets of UCITS accounted for only 70% of assets of the US mutual funds. As a result, the average European fund was five times smaller than its American counterpart. These figures have not changed much. From 2004 to the first quarter of 2006 the number of funds in the EU was between 3,3 and 3,7 times higher than in the US. The total net assets (TNA) in the EU was at about 66% to 68% of the US TNA; the relative size of EU funds even declined further from 19,9% to 18,7% of the US fund.

Figure 4: Comparison of average investment fund size in the EU and US (end 2005)



Source: EFAMA, ICI and ECB

[18] EFAMA Fact Book 2005

Distribution of UCITS funds

Distribution of funds is usually outsourced – although most often within the same group. In most Member States distribution is dominated by a few local banks and/or insurance companies. Independent entities are of relevance only in a few countries (UK, DE, IT).

Box 1: Financial institutions involved in funds distribution

Banks traditionally dominated distribution of funds in most EU countries. Banks have traditionally offered customers only in-house products, i.e. funds managed by firms from the same capital group or linked (so called "captive" distribution).

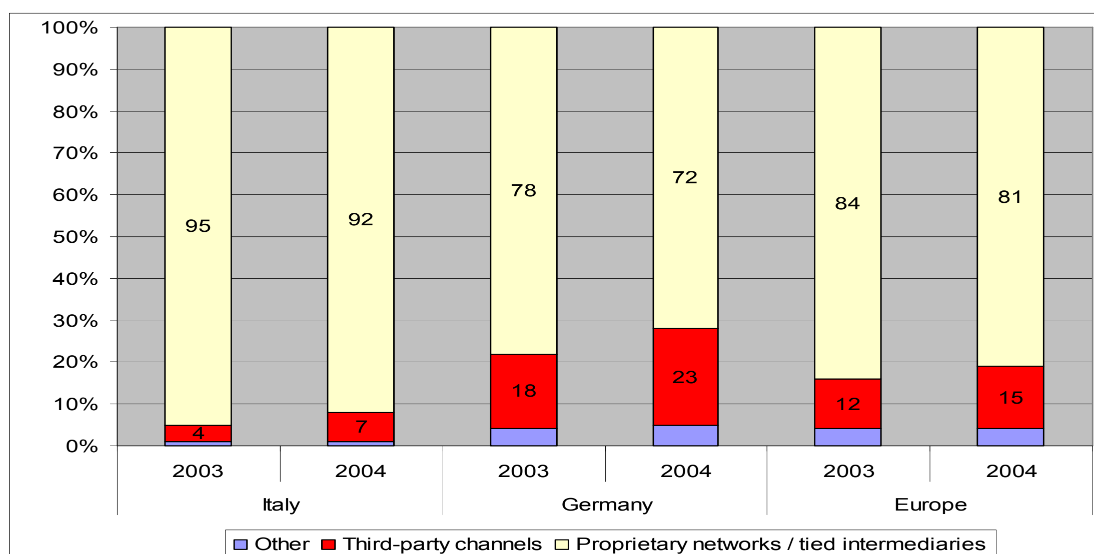
Insurance companies are another traditional distributor of funds, particularly prominent in the UK, Sweden and Germany. Funds are imbedded in a (unit-linked) life insurance contract. Distribution via insurance companies benefits from widespread networks and often from favourable fiscal treatment.

Independent Financial Advisors (IFA) are not tied to a particular product provider. They act on behalf of the investor advising him on the most suitable product from across the whole market. IFA are particularly popular in the UK. In the other EU countries, with the exception of Italy and Germany, their market share is negligible.

In recent years new trends in fund distribution have emerged. Some of them are the industry's response to encountered obstacles and deficiencies of the Single Market as described below, others respond to evolving consumer demand or technological progress:

Open architecture. Banks have started to open their distribution networks to third party funds. This allows them to attract clients by an enlarged offer. However, the move towards open architecture is slow. In 2004 third-party distribution accounted for only 15% of all distribution channels in Europe, compared to 81% share of captive distribution. In addition, in most cases distributors do not offer all available funds but only a set of funds from pre-selected fund promoters, so-called guided architecture.

Figure 5: Investment fund distribution channels (in % of total assets)



Source: McKinsey (2005)

Although from a low level, open or guided architecture is picking up in most Member States. It is estimated that 18-20% of new sales are done via open architecture. Open architecture can be seen as a way to take a hold in previously "closed" European markets. Indeed, measured as percentage of retail inflows in 2004, the share of third-party products in some countries could contribute to increasing competition at national level. Therefore, open/guided architecture and cross-border sales seem to aid one another.

Table 2: Share of third-party products in retail inflows in 2004, (in %, estimate)

By country:		By channel:	
UK:	75	Financial advisors:	79
DE:	36	Direct/other:	53
BENELUX:	23	Private banks:	35
FR:	12	Retail banks:	10
IT:	12	Insurance companies:	9
ES:	7		
Scandinavia:	6		

Source: McKinsey (2006)

The extent to which different channels make use of third-party funds differs widely, ranging from 10% or less in the case of retail banks and insurance companies to almost 80% for financial advisors.

Funds of funds have emerged as a way to circumvent rigid distribution structures and to avoid the costs of setting up local distribution systems. The diversification they offer seems to be appreciated by investors, who often are not aware of the double layer of fees that they are incurring[19]. According to EFAMA data, funds of funds are particularly popular in the United Kingdom, Austria, Germany and Belgium.[20]

Internet is another channel that allows selling investment products without having to develop costly local distribution networks. It is increasingly used to directly purchase fund units. However, to date the internet has an important market share in the distribution of funds only in some Nordic countries.[21]

PROBLEMS AND DRIVERS

The previous section has outlined the phenomenal success UCITS have witnessed over the past decade, with funds increasingly being sold on a cross-border basis and outside of the EU. Investors and regulators alike took confidence in the protections that are built into the Directive.

However, it became clear as well that the fund industry and investors are still facing problems in the dynamic context in which they have to operate. The industry is now at a crossroads:

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19 Additionally, the (underlying) funds' selection criteria used by the manager of the fund of funds is not always clearly explained to the client.

20 However, it is difficult to judge share of funds of funds in France, Luxembourg and Italy, where they are not counted as a separate category (but UCITS).

21 According to the FEFSI Fact Book 2004, 27% and 10% of funds are placed via internet in Finland and Sweden respectively.

cross-border competition is becoming keener, product innovation is accelerating and new non-UCITS savings products are increasingly attracting investors. At the same time, retail investors may decide to rely increasingly on private savings in order to secure a proper standard of living at retirement. In recent years, more and more concerns have been raised that the current regulatory framework would still be appropriate to allow industry and investors to face these challenges in an efficient and effective way. This is well-documented in the consultation on the 2005 Green Paper and the feedback statement of February 2006 summarising these comments.

Problem description

On the part of investors, major concerns relate to the lack of transparency in fund distribution regarding costs and risks of particular investment funds. Investors also challenge the restricted choice of funds they are frequently offered by distributors at relatively high costs. These high costs are often attributed to the low level of competition in some parts of the market. Furthermore, investors' possibilities to diversify their portfolio are limited.

The industry is concerned regarding the long delays and high costs of authorisation and notification procedures which leave them at a competitive disadvantage vis-à-vis competing products. As time to market is a crucial factor, delays might result in missed opportunities. Furthermore, the fragmentation of the industry or certain parts of the value chain deters the industry from fully exploiting economies of scale and specialisation gains and leaves them with unnecessarily high costs, sub-optimal efficiency levels. But it can also lead to additional operational risks. Taken together this might affect the competitiveness of the industry as a whole vis-à-vis competing products and/or similar products from third countries adversely.

The remainder of this section discusses these problems and the underlying drivers. The annex "Fiches" provides a more detailed analysis for each of the issues as part of a "mini impact assessment".

Problems can broadly be attributed to two stages of the value chain: manufacturing and distribution.

Inefficiencies at manufacturing level

Cumbersome, time-consuming and expensive authorisation and notification

The consultation process initiated by the Commission over the last year and a half and numerous other reports and analyses revealed shortcomings at different stages of the value chain. These already start with the first step in the life of a fund, namely its registration with the competent authority of the home country. On average, this authorisation takes excessively long in many Member States and often much longer than that for competing products (the Prospectus Directive[22], for example, requires authorisation within twenty days).

Related to this is the unsatisfactory functioning of the product passport: Notification for marketing in other Member States is much more cumbersome, time-consuming and expensive than a simple notification could be expected to be and, more importantly, more than for other competing products. Significant differences across Member States hinder fair competition and

[22] Directive 2001/34/EC

might lead to (unintended) discrimination. Overall, the competitiveness of the European fund industry might be put at risk.

Problems in using the management company passport effectively, inefficiencies due to lack of depositary passport

Problems exist as well at the level of the management of the fund. A management company passport is defined as the possibility a) for a UCITS to appoint a management company in another Member State or b) for a management company to establish a UCITS in another Member State. However, since its introduction in 2001 there are problems in the application of the respective provisions of the Directive, mainly due to the inconsistencies of the text and regulators concerns regarding split supervision. As a result, fund promoters have to establish fully equipped management companies in the domiciles of each of their funds. This leads to a duplication of resources and prevents them from reaping efficiency and specialisation gains. Ultimately investors have to face higher costs.

There are claims that the fact that there is no similar passporting mechanism for the depositary results in unnecessarily high costs and inefficiencies. Free choice of a depositary across Member States would add to commercial flexibility and could help to reduce costs and increase efficiency.

Proliferation of funds of small size

The European fund market is characterised by a high number of funds of small size. 54% of all funds manage less than € 50 million in assets. The average size of an UCITS is a fifth of that of its American counterpart. This impedes the exploitation of economies of scale. As a result, costs borne by European investors are excessively high. Foregone efficiency gains are estimated at € 2 to 6 bn. Fund proliferation is set to continue. Fund launches remain the preferred strategy for asset managers to innovate, raise new assets and respond to new investors' needs or preferences. This also increases the complexity of fund ranges; making it more difficult for investors and advisors/distributors to pick-up the best product.

The efficiency of the (cross-border) business of the fund industry is hampered by the difficulty or even impossibility to merge funds (cross-border) or to pool the assets of funds. Although fund mergers happen relatively frequently at domestic level, they often face very challenging hurdles that might even prove prohibitive in some cases. Cross-border mergers are the very rare exception. Only about 112 such mergers took place over the last four years (compared to 2,600 domestic mergers). One important reason for this is the absence of a common EU framework which leads to the coexistence of different national approaches and rules, rendering cross-border mergers expensive, complex and time consuming when at all possible. Another major barrier is that cross-border mergers are often considered as a taxable event what considerably undermines the scope for cost savings aimed by mergers.

Like mergers, fund pooling has been widely used in some EU jurisdictions but limited to funds in the same domicile. However, to better exploit potential scale economies pooling on a cross-border basis would be necessary. Regulators and some stakeholders perceive uncertainties related to supervision of pooled structures obstacles to cross-border pooling in the UCITS framework can be of a legal, regulatory, technical and fiscal nature. One commingling technique, entity pooling, is even explicitly ruled out by the diversification requirements of the Directive. For the other, virtual pooling, there remain considerable

obstacles of different kind. Barriers to pooling restrict access to certain (efficient) business models. Scale effects that would allow reducing costs can not be exploited.

Unnecessarily high costs, delays and operational risks in fund order processing due to fragmented systems

The lack of standardised fund order processing systems is a drag on the industry's efficiency . The current fragmentation imposed by different national systems implies that those costs, delays and operational risks step up in the case of the processing of orders of funds domiciled abroad. Developments in the industry add to the problem. Volume growth of fund transactions is requiring more efficient fund processing.[23] The growing cross-border business and changes at the distribution level translate into a growing number of actors and interlinkages that renders fund order processing more complex.[24]

Inability to exploit the opportunities offered by financial innovation

The Directive lays down rules on organisation and governance of the investment fund, risk management controls, and prescriptive provision governing fund investment policy. This is what it has been called 'product regulation' approach. However, unceasing innovation in portfolio management techniques is constantly generating new investment possibilities.

There is some concern that, if the Directive does not keep pace with market developments, there is a risk that asset managers will simply package investment propositions in more flexible regulatory formats (e.g. certificates). Furthermore, investors may decide to move to innovative investment products that might respond more closely to their needs. Those products are often subject to less strict regulatory provisions. This may pose a problem from the investor protection point of view.

Inefficiencies in fund distribution

Investors are more and more interested in savings/investment products beside their savings account and show interest in investments with a higher risk/return profile. In order to allow them choosing the most suitable products they have to be provided with appropriate information about the costs and risks of products in order to minimise the risk of “bad surprises”; be that insufficient returns, e.g. at retirement, or even the loss of capital. This need for transparent, understandable and comparable information is reinforced by the high rate of innovation in the industry, which confronts investors with ever more complex products.

Disclosure of information takes place in two ways. Firstly, there is information provided by the fund manager "on paper". Secondly, there is - in most cases - disclosure via the distributor. The latter is strongly linked to the advice function of the distributor.

Simplified Prospectus does not help investors much in their investment decision

Written disclosure by fund managers is partly regulated via the Simplified Prospectus and other transparency requirements in the Directive. The Simplified Prospectus, however, never lived up to the expectations that had been put into it. In most cases it does not provide information that is easily understood by the "average retail investor" and does not lend itself

[23] Funds Europe, August 2006.
[24] European Commission (2006c).

to comparison with other products, especially across borders. At the same time the production of the Simplified Prospectus is relatively costly and time-consuming for the industry as requirements often exceed those of the Directive and are not the same across Member States.

Total costs of buying a fund are often not transparent to retail investors

Distributors have to comply with strict requirements regarding their duty of care in advising and servicing retail investors. Any conflicts of interest and inducements have to be properly managed or disclosed. Intermediaries have to discharge the necessary duties of care to the retail client. This aspect is closely linked to MiFID, the Markets in Financial Instruments Directive 2004/39/EC. However, the way the intermediary is remunerated is often not made transparent to the investor. It is therefore difficult to judge whether the intermediary is really working in the best interest of its client or biased in his advice by other factors like retrocession fees it receives from the fund.[25] This and the perceived low level of competition in distribution might be the reasons why distribution costs are significantly higher in Europe than in US.

Since the adoption of the Directive the number of investors in UCITS funds has multiplied and the role of investment funds in household portfolios has increased considerably. Distribution channels for funds are also changing. Open or guided architecture is gaining in importance which should lead to more competition but at the same time bears some risks in terms of cost transparency, etc. Despite these tendencies toward open/guided distribution European investors are often captive clients of large banks. They are not always getting access to competitive third party funds. Or they are only getting access to third party funds at a high price.

Extending the UCITS concept to non-harmonised investment funds

There are categories of investment fund which remain outside the scope of the UCITS Directive but which are expanding quickly. They offer greater investment and risk diversification opportunities and, thus, they are attracting a broader base of investors. Non-harmonised investment funds are gradually governed by domestic regulations. Some, such as real estate funds and fund of hedge funds are already available to the retail investor in many Member States, or in the process of becoming mainstream retail investment products. Others, such as hedge funds and private equity, are generally reserved to sophisticated investors. Being outside the UCITS framework, they do not benefit from any mechanism to support their marketing on a pan-European basis. As a result, the industry is missing important business opportunities in other markets. For investors, particularly professional ones, these products could provide interesting investment/diversification possibilities.

Drivers

When analysing the drivers behind these inefficiencies and shortcomings three sources can be identified: some problems seem to result from outdated or prescriptive provisions of the existing UCITS Directive that create a (too) rigid framework for one of the most highly regulated financial services products; others seem to be due to the absence of enabling mechanisms that could help the industry to respond to new challenges that were not present or not seen when the Directive had been adopted. Finally, there seem to be problems that are not

[25] This situation is likely to improve with the new rules on inducement set out in the Commission directive 2006/73/EC of 10 August 2006 implementing MiFID.

caused by legislation or the lack thereof but are rather “homemade”, resulting from non-standardised, incompatible systems in the industry. The table below illustrates a classification of the problems outline in the previous section according to these drivers.

Table 3: Problems and drivers regarding AM efficiency

Primary source/driver: Problem area:	Directive outdated or prescriptive	Directive incomplete	Problems internal to the industry
Authorisation	X		
Notification	X		
Management company passport		X	
Depositary passport		X	
Fund mergers		X	
Pooling	X	X	
Fund order processing			X
Simplified Prospectus	X		
Cost transparency		X	(X)
Exclusions from scope of the Directive		X	
Pan-European framework for investment products		(X)	

OBJECTIVES

Overall objectives

The objective is to ensure that all players, asset managers, intermediaries and investors, can exercise their respective single market freedoms. Market players should be in the position to fully benefit from the single market freedoms established by the UCITS Directive and possibly from additional single market freedoms supportive to the functioning of the Single Market for investment funds and the efficiency of the industry. These single market freedoms do not only concern the freedom of the industry to do business but also the freedom and right of investors to participate in these markets in a fair and transparent way. But also fund providers outside the UCITS framework should be able to work efficiently on a cross-border basis. Investors with sufficient sophistication should be able to benefit from the investment possibilities offered by products registered in other Member States.

Specific objectives

The before-mentioned objectives of the existing UCITS Directive are still valid. Therefore, the objectives of this proposal coincide with those:

i) The pan-European legal framework for harmonised funds should promote an efficient and innovative fund industry that is attuned to the needs of its traditional retail investor base,

reaping all the commercial opportunities in a fully integrated European market and that is able to compete globally.

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

The specific objectives of individual measures are described in detail in the fiches in the annex. The following table summarises the problems as described above and the related objectives.

One objective that is not to be attributed to any specific area is the improvement of supervisory cooperation as it would be a conditio sine qua non for efficient solutions to many of the problems mentioned above. The existence of different approaches or cultures among Member States often leads to divergent interpretation and implementation of Directive provisions. The development of common approaches should help to strengthen supervisory cooperation and increase trust among regulators to the benefit of a frictionless protection of investor interests.

Table 4: ***Problems and objectives***

Problem area	Specific problem	Specific objectives in detail	Operational objectives
Inefficiencies at the manufacturing level	Cumbersome and costly **authorisation**: **-** Lengthy procedures before getting new products to market	- Cost savings in terms of time money and opportunities; - Easier market access; - Promotion of competition; - Creation of a more level playing field between UCITS funds promoters in different MS; -Improved competitiveness of UCITS	- Authorisation that is as cheap, easy and fast as possible without compromising effective supervision and investor protection
	Cumbersome and costly **notification**: - **-** Lengthy procedures before getting new products to other MS markets	- Eliminate barriers to integration of the European fund market; -Efficiency gains - Increased competition among UCITS - Improved competitiveness of UCITS	- Notification as cheap, easy and fast as possible without compromising effective supervision and investor protection
	Pooling: - Legal and tax barriers resulting from diverging national tax and regulatory regimes deprive AM of an effective instrument to reduce costs and benefit from economies of scale without reducing investors' choice	- Eliminate barriers to integration of the European fund market - Encourage cost savings at different levels of the value chain which are passed on to investors	- Allow AM to make a broader use of commingling techniques while ensuring investor protection and effective supervision
	Mergers: - Legal and tax barriers resulting from diverging national tax and regulatory regimes deprive AM of an effective instrument to reduce costs and benefit from economies of scale without reducing investors' choice	- Eliminate barriers to integration of the European fund market - Encourage cost savings at different levels of the value chain which are then passed on to investors	- Facilitate for cross-border mergers while ensuring investor protection and effective supervision
	Management Company Passport: - Unclear legal situation due to perceived	- Ensure that related internal market rights can be exercised	- Improve the functioning of the

Problem area	Specific problem	Specific objectives in detail	Operational objectives
	ambiguities - Incompleteness of the Directive (contractual funds excluded); - Potential benefits of the passport are significantly diminished without the ability for all UCITS types to designate a management company in another MS	effectively - Eliminate barriers to integration of the European fund market - Encourage cost savings at different levels of the value chain which are then passed on to investors	management company passport while ensuring investor protection and effective supervision
	Depositary functions: UCTIS requirement that MC and depositary need to be in the same MS hinders effective performance of fund administration and depositary functions.	- Ensure that efficient depositary functions are not hampered by an inappropriate regulatory framework	- Greater flexibility in the choice of the depositary
	Fund order processing: High operating costs and operational risks in the transactions because of fragmented infrastructure for processing fund orders	- Enhance efficiency of fund administration Reduce operating costs and operational risks	- Reduce the fragmentation of the fund order processing infrastructure
Inefficiencies in fund distribution	**Simplified Prospectus**: Complex and ineffective disclosure tool for investors	- Improve competition and transparency in distribution; - Reduce risks and improve information and choice for investors without hindering financial innovation; - More cost-effective disclosure procedures; ensure compliance of national rules and procedures with internal market principles	- Improve transparency of products by making the simplified prospectus work - Promote competition in distribution - More cost-effective disclosure
	Duty of care in selection/sale of funds:	- Provide an effective regulatory framework inductive to more competition in order to ensure that the operation of distribution channels does not undermine interests of investors and that adequate investor protection is ensured; - Ensure transparency of costs and conflicts of interest.	- Improve transparency in distribution - Ensure investor protection vis-à-vis interests of distributors - Promote competition in distribution - Ensure that conflicts of interest and inducements are properly managed or disclosed and that intermediaries discharge the necessary duties of care

Problem area	Specific problem	Specific objectives in detail	Operational objectives
Limitations of the product approach	Modernisation of **investment rules** Some investment rules might be outdated Investment decisions might be skewed by a piecemeal regulatory framework. Risk that asset managers and investors switch to non-regulated products	- UCITS funds to remain attractive, safe, robust and competitive in the face of growing competitive pressure from other products - Avoid further fragmentation of investment markets	- Clarify the definition of eligible assets
	Private placement regime: Lack of a pan-European private placement regime addressed to sophisticated investors hinders the development of pan-European markets for non-harmonised products	- Eliminate barriers to cross border fundraising and investment into non-harmonised funds	- Ensure that non-harmonised funds can efficiently be distributed cross-border while ensuring appropriate protection of different investor classes

ASSESSING AND COMPARING POLICY OPTIONS

The description of the problems and objectives has made clear that this is a multi-dimensional task: It does not have the same urgency and importance in all its aspects. It seems therefore impossible to address all dimensions with a single measure. Yet, due to the existing interdependencies and the fact that most of the issues are related to the UCITS Directive it does seem appropriate either to deal with the issues fully independently. This impact assessment therefore focuses rather on best package instead of going into the very details of each item.

This "packaging process" will be described in the next two sections. The first one describes how the measures to address a certain problem/achieve certain objectives have been evaluated. In order to keep this report at an acceptable length only a summary is provide. The detailed analyses can be found in the Annex "Fiches". The second section evaluates the best way and timing to implement the measures from a more general point of view to ensure overall consistency and efficiency.

Assessing and comparing individual measures

Following the description of the problems and the definition of objectives a number of options which could help to address the problems and to achieve the objectives have been identified. These options and their likely impacts are presented shortly in Table 5 below. In addition, the table gives an indication of the extent to which the respective option would have an impact on efficiency, market integration and investor protection. Together with Table 4 it provides a very condensed summary of the impact assessments that have been prepared for the individual issues outlined in section 4.[26]

The next paragraphs summarise the reasoning behind the selection of preferred options (marked in bold) shortly for each issue. As the option "do nothing" would have the effect that the current problems would continue to exist or might even aggravate in all cases this option is not described in further detail.

[26] The complete assessments can be found in annex 5 "Fiches for individual issues".

Notification: *i)* The introduction of a *service passport* would replace the product approach by a service focused approach, i.e. authorisation of the manager and not of the product. Therefore, the need for notification would disappear. Although this would most likely considerably improve efficiency in bringing UCITS products to foreign markets and thereby contribute to market integration, it would put the "UCITS brand" at risk and could have unintended negative impacts on investor protection. The possible negative impacts of this option seem to outweigh the positive ones. *ii)* ***Amending the Directive*** with deadlines for the notification procedure and a switch to regulator-to-regulator notification would contribute to a downward harmonisation in terms of costs and duration of the procedure. It would improve the efficiency and foster market integration. It would also have positive impact on investors as investor protection would remain ensured while choice would increase and costs potentially decline. *iii)* It seems that with the adoption of guidelines *CESR* has reached the limits permitted by the Directive. For this reason, it is unlikely that further work could lead to substantial improvements.

Authorisation: *i)* An *amendment of the Directive* could introduce deadlines for national authorities. This would shorten the time to market for new domestic funds. *ii)* The reasoning concerning the option to introduce a *services passport* is similar as for the case of notification. However, in contrast to the case of notification national authorities should prima facie have an incentive to get domestic funds registered fast. Recent experience seems to confirm that they are working in this direction. For these reasons it seems best to ***do nothing***, not to interfere at European level, but to leave the issue with Member States in accordance with the principle of subsidiarity.

Mergers: *i)* An ***amendment of the Directive*** could enable cross-border fund mergers. This would help to improve both efficiency and market integration as economies of scale could be exploited and pan-European strategies be developed. Investors should benefit from this through cost savings and eventually improved competition in and competitiveness of the industry. *ii)* The *promotion of convergence* of national regimes does not promise any major improvements as this road was already open to Member States in the past but no significant progress has been made. Therefore option i) is preferred. Options i) and ii) could be accompanied by *iii)* a *Tax Directive* that would ensure that cross-border fund mergers are treated in a tax neutral way. This would considerably increase the effectiveness of the previous options but given the unanimity requirement in Council this seems not achievable in the short- to mid-term, if at all. Or by *iv)* an *interpretative communication* that would emphasise the application of case law in a systematic manner in order to avoid tax discrimination between domestic and cross-border fund mergers. Here it is difficult to see to what extent this could result in a significant improvement of the situation but given the low chances to get a tax directive adopted this seems to be the best solution for the moment.

Asset Pooling: *i)* An ***amendment to the Directive*** would be needed to allow managers to make use entity pooling techniques. This would provide the industry with some flexibility in their cross-border business models and help market integration. Investors should benefit from cost savings. *ii)* As some pooling techniques carry some uncertainties and potential regulatory problems allowed entity pooling structures could be restricted to the so called *master-feeders*. This would reduce the positive benefits to the industry but also the associated uncertainties regarding investor protection. *iii)* An ***amendment to the Directive*** to allow virtual pooling, on the other hand, would increase the potential efficiency gains. However, particular attention should be given to the design of provisions aiming at alleviating supervisory concerns. *iv)* CESR guidelines could reduce regulators' reluctance to authorise (cross-border) virtual pooling structures. Its impact would depend very much on the compliance of Member States

with such guidelines. Because of their greater positive impact on efficiency and integration, options i) and iii) are preferred. It has, however, to be ensured that the inherent risks are sufficiently dealt with so that investor protection is guaranteed.

Management company passport: i) An ***amendment to the Directive*** to fine-tune existing provisions and to eliminate potential inconsistencies in the rules could make the passport a much more effective tool as it is at the moment. Positive impacts could be expected in all three respects: efficiency, market integration and savings for investors. It is therefore the preferred option. *ii) CESR guidelines* could help to significantly improve supervisory cooperation in order to reduce frictions and delays. It would not, however, solve all the identified problems (e.g. ambiguous Directive drafting). Besides, their effectiveness risks to be limited given their non-binding nature. *iii)* Instead of acting now, the situation could be *further analysed* to avoid changes that disturb the industry without producing significant benefits. However, this risks delaying an urgently needed solution.

Table 5: Summary of impact assessment for individual problem areas

	Assessment of impact on:			
Available options	**Efficiency**	**Market integration**	**Investors**	**Feasibility**
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	-	-	-	
Authorisation				
Amend UCITS Directive: deadlines for procedures	+	?	+	Yes
Service Passport replacing product authorisation	++	?	--	Doubtful
Do nothing	+	?	+	
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	-	-	-	
Entity pooling				
Amend Directive to allow entity pooling	++	++	++	Yes
Amend Directive to allow master-feeders	+	++	++	Yes
Do nothing	-	-	+	
Virtual pooling				
Amend Directive to allow virtual pooling	++	++	++	Yes
CESR guidelines on virtual pooling in order to reduce barriers	?	?	+	Yes
Do nothing	-	-	+	
Management Company Passport				
Amend Directive to make passport work: fine-tuning of existing provisions/elimination of potential inconsistencies in the rules	++	++	++	Yes
CESR guidelines to give effect to Art. 6c cooperation provisions	?	?	+	Yes
Two-step approach: analyse situation + act on the basis of results	+	+	++	Yes
Do nothing	-	-	+	
Depositary Passport				
Amend Directive to enable full passport for depositary services	+	+	+	Doubtful

Available options	Assessment of impact on: Efficiency	Market integration	Investors	Feasibility
Amend Directive to enable custody passport only	+	+	+	Yes
Greater cross-border flexibility for depositary business models	++	++	≈	Yes
Do nothing	-	-	+	
Fund order processing				
Amend Directive to harmonise fund order processing	?	?	+	Doubtful
Soft-law: issue a recommendation to encourage greater harmonisation and automation of processes	?	?	?	Yes
Do nothing	-	-	≈	
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	-	-	-	
Duty of care				
MiFID: Monitor implementation and effectiveness	≈?	≈?	≈?	Yes
Vade-mecum or guidance on specific problems	≈?	≈?	≈?	Yes
Clarification of the interplay between UCITS and MiFID	≈?	≈?	≈?	Yes
Do nothing	≈?	≈?	-	
Non-harmonised funds				
Amend Directive to include non-harmonised funds that are suitable for retail investors	+	+	-	Doubtful
Analyse if pan-European private placement regime is appropriate and if so implement it	+?	+?	+?	Yes
Do nothing				
Investment rules				
Amend Directive to enlarge investment powers	+	+	?	Doubtful
Amend Directive to introduce Lamfalussy approach, then level 2 measures	+	+	+	Yes
2-step approach: analyse use of investment powers; then develop appropriate measures	+	+	+	Yes
Do nothing	-?	-	-	

Assessment: ++ = strongly positive; + = positive; -- = strongly negative, - = negative; ≈ = neutral; ? = uncertain; **Preferred option in bold**

Depositary passport: *i)* An amendment to the Directive to enable a "*full passport*" for depositary services would include provisions aimed to harmonise the role and responsibilities

of depositaries. This should trigger efficiency and specialisation gains, facilitate cross-border business, and increase investor confidence. But the scope for benefits does not seem to justify the important efforts that would be required. *ii)* A *custody passport* would still require important efforts while providing more or less the same benefits. *iii)* Allowing ***greater flexibility*** in the organisation of the depositary function would not require legislative change but some adjustment in the rules and practices of some Member States. That last option appears to be the most cost-effective.

Fund order processing: *i) Amending the Directive* to harmonise fund order processing could help the industry to overcome the difficulties in developing and agreeing on an efficient system. It would, however, risk distorting incentives and might hinder the development of economic solutions in the future should need arise. *ii)* A *recommendation* could be used to encourage greater harmonisation and automation of processes without interfering directly with legislation that would be inflexible to react on developments after adoption. But at the same time, a recommendation would be of uncertain use due to its non-binding nature. Therefore, it seems most appropriate to ***do nothing*** and let the industry continue its own work, the more so as recent initiatives show a certain chance of success.

Simplified Prospectus: *i) CESR guidelines* on coherent and uniform implementation could potentially achieve some benefits but are restricted by the provisions in the Directive. In addition, their impact depends very much on the compliance of Member States with the guidelines. *ii)* Modifying *Recommendation* to clarify certain elements of the Simplified Prospectus would face similar problems and restrictions. *iii) Abolishing* the Simplified Prospectus as a drastic solution would at first glance reduce the costs of the industry and reduce administrative burden. It would, however, not be unlikely that it be replaced by some other documents. *iv)* ***Amending the Directive*** to specify core principles and to introduce the Lamfalussy approach for future adaptations would allow for more harmonisation and flexibility at the same time. *v) Clarification* of definitions via a Level 2 measure would, like options i) and ii), carry a rather low likelihood of significant impacts. Therefore, a re-write of the rules governing the Simplified Prospectus seem to be the only option warranting sufficient net benefits for all market players to justify action. As the preferred option will only be "operational" with the usual delay of lawmaking at European level, a modification of the Recommendation might be used as a short-term solution which could then eventually be transformed into a level 3 measure under the amended Directive.

Duty of care: *i)* ***Monitoring*** the implementation and effectiveness of MiFiD with a specific focus on the impact on the distribution of UCITS would make sure that any problems could be addressed immediately and would further trust in the legal framework. *ii)* The issuance of further *guidance material* would be pre-mature at this stage. *iii)* The same holds for the issuance of a *clarification* of the interplay between the two Directives.

Non-harmonsied funds: *i) Amending the directive* to make (some) non-harmonised funds UCITS would require to either drop or soften some of the core principles of UCITS or to establish sub-categories with the risk of a fragmentation of the UCITS landscape. *ii)* In order to overcome the fragmentation of regulation on non-harmonised funds in the EU a pan-***European private placement regime*** addressed to sophisticated investors might be the best solution, but the feasibility and appropriateness of such a regime would first need to be analysed further.

Investment rules: *i)* Through an *amendment to the Directive* UCITS could be allowed to invest in products which were not eligible investments up to now and adapt other rules like

investment limits to provide asset managers with more flexibility in their investment strategies.. *ii)* With a *Lamfalussation* of the respective provisions could allow more flexible reactions in the future but level 2 work would be restricted to clarification and therefore still considerably restricted. *iii)* As it is not clear in how far the 2001 amendments have influenced the investment policies of UCITS it seems more appropriate to ***analyse and compare investment policies*** of harmonised and non-harmonised funds before taking action.

Combining the measures into a package

The analysis of the individual issues in the previous section resulted in a list of actions that appear suitable to solve or at least alleviate the respective problems to the extent possible. The preferred options for the individual problem areas differ widely in form, – from "do nothing" to legislative proposals –, and timing, – from immediate action to potential action at a later stage. In a next step, it has to be analysed what the way would be to implement these measures. This includes considerations in how far the measures are consistent with each other, if there are any synergies that can be exploited or conflicts to be avoided, or flanking measures to be taken to round up the package.

In principle there are three options:

firstly, the individual measures could be implemented "as they come along", i.e. whenever a measure has been prepared it will be immediately implemented

secondly, all measures could be implemented at the same time, i.e. as soon as all have been properly prepared

thirdly, measures could be split up into sub-groups of measures as a compromise between reacting swiftly on the most pressing issues and minimising the number of changes to the provisions.

The advantages and disadvantages and more general considerations in this respect are discussed in the following.

Implementation of individual actions

The advantage of this would of course be that no time is wasted. No measured had to be halted until others have been prepared. However, given that many measures would be ready for implementation within a relatively short interval; this would produce a constant stream of legislative changes and accompanying actions like level 2 and level 3 work. This could lead to some confusion in the legislative process. But it would not allow making proper use of potential synergies between the measures. Because of the short intervals it would not have the benefit that the impacts of earlier measures could be taken into account in the preparation of others. This approach would put a heavy burden on the legislative system at EU and national level without providing particular benefits and also on the industry that has to comply with. It will also create incertitude. For the sake of better regulation this option is not analysed in further detail.

Implementation of all potential measures at the same time

This option would avoid the shortcomings of the first option. Legislators at EU and national level would be spared of frequent small amendments to the Directive and industry would not have to adapt to new rules "every day". In addition, option 2 would potentially allow maximising synergies between the different actions.

It would also be advantageous in terms of consistency of the overall approach. It could, for example, be envisaged not only to implement Lamfalussy-structures in those parts of the Directive on which the above measures are targeted but for the Directive as a whole. At the same time the product-based approach of the Directive could be replaced by a risk-based approach. As explained in the discussion of the investment rules, this would improve the flexibility of UCITS considerably.

The disadvantage of this option is that – as the analysis regarding investment rules and the treatment of non-harmonised funds showed – there are still a number of vital questions to be answered before such a complete overhaul of the Directive could safely be proposed. In other words, implementation "in one go" would either risk that quick and perhaps premature action in some areas. It would produce adverse outcomes that could not be seen yet, or mean that more urgent measures that could safely be implemented in relatively short time would have to be delayed until the more complex issues regarding investment rules etc. could be addressed with sufficient confidence.

Implementation of sub-packages

This last option would take the form of a White Paper that clearly indicates what measures are envisaged in the different areas and when they are to be implemented. This would help market players and regulators to plan ahead. Sub-packages would be designed that take the nature of measures, the urgency and the degree of understanding of the issue into account. Legislative measures to improve the efficiency of the industry, for example, are considered as priorities that should not be delayed. In contrast, the outcome of the analytical work proposed regarding issues like private placement and investment rules should not be cut short and results should not be anticipated.

Furthermore, this staged approach would not exclude further measures on the basis of the analyses. Of course, there might be a disadvantage in this compared to option 2 in that two major amendments to the Directive would take place within a few years. Compared to the risk to get it wrong now or the costs of delaying the more straightforward changes to the Directive by probably some years this option still seems to be preferable. A majority of market players also seems to prefer this option.

The publication of these intentions of the Commission would provide stakeholders with a certain level of legal certainty for the next years. It would set out a clear time table for flanking measures like monitoring work, compliance cost analysis and further studies of some issues on which current knowledge does not allow for immediate action. Furthermore, it would give a clear indication of how regulation could be developed further after 2008.

Considering the advantages and disadvantages of these three options, the staged approach of a white paper seems to be the most appropriate as it allows to combine the main benefits of options (1) and (2), namely swift action on the most pressing items without excessively frequent changes to the Directive.

MONITORING AND EVALUATION

While an exhaustive monitoring and evaluation programme can only be developed once detailed proposals have been developed, such a programme will most likely comprise the following elements:

Monitoring of the implementation of MiFID and its impact on UCITS

Study on investment policies of harmonised and non-harmonised fund, evaluating the use actually made of the enlarged investment powers introduced by the 2001 amendments and assessment of its impact and need for further action

Review national conditions for authorisation and marketing of non-harmonised funds to the public (mass-market)

Evaluation of the amended directive, four years after it entered into force

Further analysis of the need for a switch to a principle/risk-based approach in the directive

ANNEX 1: Summary Table of Actions

PROBLEM AREA	PREFERRED OPTION	TYPE AND TIMING
Authorisation	Do nothing	-
Notification	Amend UCITS Directive: deadlines for procedures; regulator-to-regulator notification	Legislative change 2007
Fund mergers	Amend Directive: enable fund mergers Interpret. Communication: application of national rules to cross-border mergers	Legislative change 2007
Asset pooling	Amend Directive to allow entity pooling Amend Directive to allow virtual pooling	Legislative change 2007
Management company passport	Amend Directive to make passport work: fine-tuning of existing provisions/elimination of potential inconsistencies in the rules	Legislative change 2007
Depositary passport	Promote greater cross-border flexibility for depositary business models	Legislative change 2007
Fund order processing	Do nothing	-
Simplified Prospectus	Amend Directive: specify core principles, Lamfalussy approach for future adaptations	Legislative change 2007
Duty of care	MiFID: Monitor implementation and effectiveness	
Non-harmonised funds	Analyse if pan-European private placement regime is appropriate and if so implement it	Report 2008
Investment rules	2-step approach: analyse use of investment powers; then develop appropriate measures	Report 2008

ANNEX 2: The Lamfalussy process

The new regulatory structure of the so-called Lamfalussy process has been initiated by the Stockholm European Council Resolution of 23 March 2001 on “more effective securities market regulation”. The Lamfalussy process is based around the four-level regulatory approach recommended by the Committee of Wise Men on the Regulation of European Securities Markets, chaired by Baron Alexandre Lamfalussy[27].

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[28] – and the **Committee of European Securities Regulators (CESR)**. The two Committees were set up by Decisions of the Commission on 6 June 2001[29]. The ESC acts in its capacity as a regulatory committee, assisting the Commission in the exercise of its delegated executive powers, within the terms defined in the Directives adopted at Level 1.

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

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

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27 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

28 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.

29 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 6: The four-level regulatory approach under the Lamfalussy process[30]

LEVEL 1

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

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

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

ANNEX 3: List of acronyms

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

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ANNEX 5: Fiches for individual issues

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Note:

This document adds more detail to the impact analysis that has been presented in the Impact Assessment report. The sections follow the common reporting format: Problems – Objectives – Options – Impacts – Comparison of options. The analyses are primarily based on the sources mentioned in the introduction of the report. In addition to that various statistical data sources and reports by various organisations have been used. The kind cooperation of these organisations and companies helped a lot in "getting the facts right" and is therefore very much appreciated. Nonetheless, the assessments presented in this document are those of the Commission services.

PROBLEMS WITHIN THE UCITS FRAMEWORK

Manufacturing level

Despite the Directive's ambition to create a single market for UCITS, the European market remains rather fragmented. This fragmentation appears at different levels.

First, at the level of the fund offer. Member States' fund markets are often dominated by domestic products. The presence of foreign funds, although rapidly increasing over the last years is still modest. Only 17% of the funds on the market are cross-border[31]. Part of this domestic bias can be justified by investors' preferences, historical inertia and divergent taxation regulations[32]. Lengthy and cumbersome notification procedures add to the problem. As a result, parallel ranges of rather similar funds are developed in different Member States. This fund proliferation is exacerbated by the continue launch of funds responding to evolving investors' needs or new business opportunities. The European fund market is thus characterised by a high number of funds of small size[33]. 54% of all funds manage less than €50 million in assets[34]. Given the existing difficulties to put in place mechanisms for amalgamating assets (such as fund mergers or asset pooling) this situation is set to persist. Inability to exploit economies of scale translates into higher costs.

Second, at the level of some industry value-chain activities. The choice regarding the location of financial activities depends on a series of variables such as access to qualified man-force, regulatory and/or tax regimes, proximity of liquid and developed markets and the possibility to exploit economies of scale through concentration[35]. However, in the case of UCITS industry this choice is curtailed. 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 limited in practice to some secondary activities. 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 put up costs.

Third, at the level of the organisation of processes. The treatment of a subscription or redemption order implies a series of interactions between different actors and varied (often manual) steps. This process is generally organised differently between Member States; sometimes even within the same national market. The lack of automation and standardisation increases costs and delays and can exacerbate operational risks.

The consequences of these single market inefficiencies are not negligible. At the European level, the investor bears their whole burden in terms of lower net performances and higher risks. UCITS struggle to remain attractive vis-à-vis other investment products. Delays in the

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[31] Lipper and EFAMA data for 2004. A cross-border fund is considered as that notified for sale in at least another two EEA jurisdictions other than its domicile.

[32] Other often mentioned obstacles to a further market integration relate to distribution aspects that will be discussed later in this report.

[33] The average fund size of a UCITS is nearly 6 times smaller than the average size of an American mutual fund (€ 946 million). EFAMA and ICI data for December 2005.

[34] European data from Data Digest 2006, FERI Fund Market Information, March 2006.

[35] "Current trends in European asset management. Lot 2" Oxera, September 2006. (referred as Oxera report in further sections)

authorisation of new UCITS products aggravate the problem. On the global scene, the competitiveness of the European fund industry is severely damaged[36].

In order to overcome these drawbacks a series of solutions have been identified and largely discussed with all stakeholders over the last two and a half years. Those are detailed and analysed below.

Authorisation

Authorisation, that is permission from the competent authority in the home Member State, is at the core of the UCITS product passport. It confirms that the UCITS funds complies with UCTIS rules and can be marketed to public. In authorisation procedure different types of cost are incurred. When seeking approval by the regulator the fund manager/promoter is usually faced with direct costs to be paid to the regulator in the form of fees and indirect costs in the form of compliance costs (staff time or the use of external expertise). The regulator has to bear the costs incurred by the checking of the documents issued by the funds promoter; these costs can either be passed on to the fund manager and would then be (part of) the fees or be borne by the state. Finally, there are opportunity costs of the time taken for authorisation and notification.

It should be noted that authorisation costs do not only occur with the initial authorisation of a fund but, in most Member States, fees are due every year. Furthermore, there are additional costs every time changes are made to the fund[37] which needs to be authorised by the regulator and require further expense. What is probably even more important to funds promoters is the delay that the authorisation process incurs.

Problem description

Administrative delays in getting investment funds to the market

Obtaining authorisation in the country where the fund is domiciled can be a lengthy process. This situation penalizes UCITS with respect to other, competing products that provide less investor protection.

As the UCITS directive does not fix a maximum time for the authorisation procedure this time varies considerably between Member States (see Table 1) ranging from one to two weeks up to three to six months. The industry claims that the procedures are unnecessarily long and could easily be improved by the use of modern information technology and by allowing producers to refer to their "track records" instead of reproducing and double-checking all documents every time a new fund is produced by the same provider.

Lengthy authorisation procedures do not only produce (unnecessarily) high direct costs, they can also reduce or even destroy business opportunities if, as a result of delays in authorisation, products do not make it to the market in time or not at all. Especially for newly developed products there is a race to the market in order to benefit from the first mover advantage resulting from the early recognition of the product by distributors and investors.

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[36] A Fitzrovia/Lipper survey in September 2005 shows that European cross-border equity funds are twice as expensive as US funds and that, as regards to bond funds, this relation is 1.6 to one.

[37] Irish interviewees suggested that this could happen up to three times a year. This is broadly consistent with the statistics presented by EFAMA / IMA which estimated that pan-European providers have cost of approximately € 0.5 million per year to maintain registration.

Table 1: Time taken to get fund authorisation

Member state	Fund authorisation
Belgium	1-2 weeks
France	4 weeks on average
Germany	3 weeks
Ireland	6-8 weeks on average
Italy	Consob reviews prospectus in 20 days, Bank of Italy review of fund rules 40 days
Luxembourg	2-8 weeks depending on the file
Poland	5-6 months
Spain	Typically 1 month, but up to 2 months
Sweden	3 months, 6 months for complex fund
UK	6 weeks

Source: CRA (2006) based on interviews with fund managers and regulators.

Industry claims that both uncertainty and long delays seriously handicap the fund industry when competing with other financial products offering similar features. While authorisation of a UCITS product often takes several months, the Prospectus Directive limits this process to 20 days. These differences might encourage providers to focus more on less regulated products which grant less investor protection. In the end, the claimed objective of authorities to ensure investor protection would be seriously undermined.

From a market prospective cumbersome and lengthy authorisation processes could have significant dynamic impacts: denied market opportunities for the industry result in less choice for investors. Both, industry and investors suffer higher costs directly through the authorisation and indirectly due to the restricted size of the market (foregone economies of scale). In the end, the competitiveness of the European funds industry might suffer.

It has to be noted that the CRA study signalled a positive trend in terms of greater speed of authorisation. Many fund managers stressed that their national regulator was improving in the speed of authorisation (Sweden, Poland, Germany) although many also stressed that there was still a long way to go. At the same time, a reduction in the time to market is not expected to reduce differences in the regulatory compliance cost for funds in different Member States. Instead, its main impact seems likely to come through additional dynamic competition between funds which are able to access markets more easily.

Cost of authorisation

According to CRA (2006) the overall costs of regulatory compliance of a fund are small. Since authorisation is a part of these total costs, it follows that the respective costs are also relatively small. However, as illustrated in Table 2, these costs vary considerably between Member States which might be an indication of saving potential in some Member States.

The financial cost of authorisation in terms of internal resources and use of external lawyers, often accounts for less than 0.25 basis points (bps) for the largest providers. Overall, regulatory costs have been found to be a small component of the total costs of investment funds with an average cost of between 1.3 and 2.3 bps depending on the type of fund under consideration.

Table 2: Cost of authorisation

Direct cost imposed by regulators			
Member State	*Single fund*	*Umbrella fund*	*Frequency of payment*
Belgium	€0.075 per thousand assets under management plus €0.50 per thousand new subscriptions; for money market funds the cost is €0.05 per thousand net asset value with a minimum of €314.	Same	Annual
France	€8 per million of assets under management	Same	Annual
Germany	€1,500	€1,500 per sub-fund	Annual but only €500 per sub-fund
Ireland	€2,050	€2,050 plus €550 per sub-fund up to a maximum of €4,800	Annual
Italy	€1,400	Same	Annual
Luxembourg	€2,650	Same	Annual
Poland	€4,000	€4,500 for umbrella and €300 for subsequent additions of sub-funds	One-off
Spain	0.014% of estimated sales with range of €975-39,033 for fixed income and €1,626-65,055 for variable income	Same	Applied one-off or as long as the estimated sales increase
Sweden	SEK 5,000 (€ 540)	Same	Annual
UK	£1,200 (€1,735)	£2,400 (€3,470)	Annual fee varies according to the number of sub-funds and varies from £620 - 13,640 (€900 -19,720)

Source: CRA(2006) based on interviews with, and data from, regulators. Where fees are noted as annual then annual payments are the same as the initial authorisation costs unless otherwise specified.

Objectives

The specific objectives here are:

- easier market access
- promotion of competition
- creation of a more level playing field between UCITS funds promoters in different Member States and
- improved competitiveness of UCITS vis-à-vis other investment products and providers from third countries

The operational objective is to make authorisation as cheap, easy and fast as possible without compromising effective supervision and investor protection. Cost savings should ideally be passed on to investors. Overall, this measure should lead to a downward harmonisation in terms of costs and time for authorisation.

Description of options

i. Do nothing

Current problems persist, leaving investors with relatively high costs and perhaps restricted choice. There is a risk that investors turn towards other, less regulated and more risky investment products. Industry would face (unnecessarily) high costs and slow access to market resulting in a competitive disadvantage vis-à-vis providers of non-UCITS and provider of investment funds from third countries.

ii. Amendment of the UCITS Directive

In an amendment of the Directive a maximum time span for authorisation by national authorities could be fixed. This requirement could follow the example of the Prospectus Directive: authorisation of new (umbrella) funds in 20 business days; notification of incomplete documents to the provider within 10 business days; approval of changes to the prospectus or to the fund rules/instrument, and of the addition of a new sub-fund within 10 days. In addition, the amendment of the Directive could clearly specify what additional requirements by national regulators were acceptable and what not.

iii. Introduction of a Service Passport

This option would replace the current product authorisation by a collective investment scheme service passport for the operator of the UCITS scheme. Once an operator has been authorised it could issue funds via a self-authorisation process. This option would eliminate any regulatory delay in the marketing process of new or altered funds. At the same time it would make the notification procedure obsolete. Therefore, it would represent the most radical solution in terms of reduced product-related compliance costs. Without product authorisation, investor protection would be ensured via the initial check of the service provider and in the distribution via MiFID rules.

Impact assessment

i. Do nothing

If no action is taken the current problems would persist. In the medium to long term there is a risk that both fund promoters and investors increasingly turn to non-UCITS. Contrary to regulators' aims, risks borne by retail investors would even increase, in some cases probably involuntarily. CESR seems to have exploited its potential to speed the authorisation process up to limits of existing directive. Therefore, there are considerable doubts whether further improvements could be expected from multilateral work at EU level in the near future. However, home Member States should have an interest to make the authorisation procedure as frictionless as possible. Only this way they can hope to attract new funds or at least that domestic asset managers keep notifying new funds at home. Recent experience seems to show that more and more Member States take this road and try to shorten the authorisation process. Therefore, "do nothing" at EU level might not result in a deterioration of the situation over time but to some improvement.

ii. Amendment of the UCITS Directive

Assuming that the proposed changes were properly and implemented in a relatively harmonised way, these amendments could lead to considerable reduction in the administrative burden on fund promoters of UCITS funds. Although no immediate cost reductions could be envisaged for investors, the potential increase in competition and improved competitiveness of UCITS products could create benefits for both collective investment schemes and investors. These combined effects should also provide investors with a better choice among domestic and cross-border state-of-the-art products.

On the downside, the reduction in the time available to regulators in the authorisation process might require more (human and IT) resources to ensure the same level of reliability and investor protection. This impact could at least partially be offset by the use of more efficient means of communication etc. Another disadvantage would be that the legislative process would not allow for changes to take effect within less than three years at best.

iii. Introduction of a Service Passport

The introduction of a service passport would mean a fundamental disruption in the approach and "philosophy" of the UCITS Directive. It would represent a deviation from the "product approach" of the Directive and thereby provoke a series of knock-on effects. Besides posing several legal problems, it would have a considerable impact on the perception of the UCITS brand and would put more stress on MiFID than was originally foreseen. Furthermore, it would put an end to the regulatory stamp of approval for UCITS products. This product approval, however, is at the core of the UCITS brand which assists operators to sell the UCITS product outside the EU. The consequences of such a re-write for investors are hard to foresee, given that MIFID itself is still in the process of being implemented. It can not be ruled out that self-authorisation of products could lead to lengthy and fierce disputes between fund promoters and regulators about eligibility issues with delays in procedures.

Comparison of options

Option i would not envisage any action at EU level; however, there seems to be some positive development at national level recently. Some Member States have succeeded in considerably shortening the authorisation process. In order to keep or even attract business each Member

State should have sufficient incentive to deal with authorisation requests as quickly as possible.

Option ii would not provide quick solutions. But as there is no real urgency this would not be a major shortcoming. It could be expected that the proposed changes lead to more competition in and competitiveness of the industry. For supervisors which do not have sufficient resources this would require stocking up its resources in order to ensure the same level of investor protection as under the current regime. At the same time, this option might result in frequent exchange of "unproductive" regarding the extension of deadlines when additional information is needed. It might also give the impression to third parties that the UCITS "seal of approval" is watered down to some extent. Therefore, there is no clear benefit to be seen from this solution compared to option i.

Option iii, on the one hand, might ultimately result in faster time to market once the firm had received its service passport but that benefit might be marginalised when option 2 were implemented. On the other hand, it could put the whole industry in danger by "destroying" the UCITS brand and the feature which most prominently distinguishes UCITS from other investment products. Therefore, the expected net benefit seems to be lower than that of option ii and there is a non-negligible risk that it might even be negative.

In conclusion, neither option ii nor iii seem to provide clear benefits that would justify action at EU level at the moment.

Table 3: Overview of impacts

Option		Enhance market efficiency	Maintain high levels of investor protection	Observations
1	Do nothing	≈ +	≈ +	Current problems persist
2	Amendment of the Directive	≈ +	≈ -	
3	Service passport	≈ +/- ?	≈ -	Severe interference with the "UCITS philosophy"

Table 4: Impacts

Option	Affected parties Directly: D Indirectly: I	Impacts Positive: +. Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Timing One-off, Short-, Mid-, Long-term **Nature:** Dynamic / Static	Likelihood Certain High Medium Low	Remarks
1. Do nothing	Industry: D	≈/- long and cumbersome procedures ≈/- high costs ≈/- negative impact on market integration and efficiency	Permanent Dynamic		
	Investors: I	≈/- less choice/later access	Permanent		
	Authorities D	In some cases inefficient procedures			
2. Amend the Directive	Industry: D	≈/+ faster and lighter procedure ≈/+ level playing field with non-UCITS ≈/+ improved competitiveness	mid/long-term	Medium	
	Investors: I	≈/+ more choice between competitive up-to-date products	mid/long-term	Medium	
	Authorities D	≈ adjustment of procedures ≈ staff implications	One-off Mid/long-term; static	Medium	
3. Service passport	Industry: D	≈/+ fast access to market for new product - risking positive UCITS brand image	mid-term; dynamic	Medium	
	Investors: I	≈/+ more choice between competitive up-to-date products - increased product risks	Mid-term; dynamic	Medium	
	Authorities D	≈ switch from product to service approval	long-term; static	Medium	

Notification

The UCITS Directive of 1985 introduced a product passport and a notification procedure in order to create a pan-European retail investment funds market. Notification instead of multiple authorisations in all Member States where a promoter intends to market a fund was seen as an efficient approach to supervision, a measure to considerably reduce costs and time requirements in bringing new funds to the market.

The notification procedure requires that the UCITS fund informs the competent authorities of the home and host country of their intention to market the fund in another member state and also that the fund provides the host country's authority with additional documentation (e.g. simplified prospectus, fund rules, annual reports, marketing arrangements etc).

Problem description

Administrative delays in getting investment funds to foreign markets

Contrary to the original idea of the UCITS Directive, a lot of additional time, effort and cost is required if a fund promoter intends to notify funds for sale in other Member States. In the situation, promoters of UCITS in other Member States than its domicile are penalized not only with respect to other, competing products that provide less investor protection but also vis-à-vis domestic products.

In many cases UCITS notification has turned into a kind of additional authorisation rendering pan-European distribution of funds a time-consuming, cumbersome task, a (unnecessarily) challenging job. The benefits of these administrative burdens are often hard to see. Only the incorrect application of the UCITS Directive in the authorisation process by certain Member States could justify such "double-checking". However, such infringements of the Directive should rather be notified and solved via infringement procedure.

The additional requirements by host Member States (translation requirements, costs, deadlines, etc.) vary a lot across Member States. The resulting delays and uncertainty keep the industry from exploiting economies of scale and hinder the development of an integrated market.

Currently the notification process often uses out-dated procedures instead of using modern information technology and allowing producers to refer to their "track records" instead of reproducing and double-checking all documents.

The costs of these shortcomings manifest mainly as opportunity costs and missed opportunities for fund promoters and investors which are impossible to quantify. But especially for newly developed products there is a race to the market in order to benefit from the first mover advantage resulting from the early recognition of the product by distributors and investors. This is not only relevant for the home market. Successful and efficient marketing of new products often depends on the achievement of sufficient market size.

The fact that the Directive is not clear in indicating the requirements, i.e. which documents need to be translated or when they are needed might be the fundamental reason why notification became so burdensome. However, at the same time, there seems to be certain distrust among national regulators, perhaps reinforced by the difficulties some authorities might have in understanding ever more complex UCITS products.

As notification has to be done within three days under the Prospectus Directive, while it can take two months for UCITS there is no level playing field between UCITS and non-UCITS. This difference might encourage providers to focus more on less regulated products which grant less investor protection. In the end, the claimed objective of authorities to ensure investor protection would be seriously undermined.

From a UCITS prospective this could result in less choice for investors and an industry that is denied opportunities. Both, industry and investors suffer higher costs: The degeneration of notification into licensing reduces the competitiveness of UCITS products. These problems become more and more severe as pan-European business is increasingly a work-a-day reality. For example, 66% of net sales of UCITS in 2005 went to cross-border funds[38].

Delays in time to (foreign) market potentially reduce competitive pressure in the industry and might therefore have a negative effect on costs and the prices consumers face. To the extent that delays might keep fund promoters from entering a specific market at all, they would as well result in a restricted choice to consumers.

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[38] These are funds domiciled in Luxembourg and Ireland. It should be however be noted this figure includes also round-trip funds (i.e. funds domiciled in a country but sold exclusively in the country of the promoter).

Delays in notification are regarded as having severe impact on the chances a new product has in a foreign market. Although such delays might not be used as a deliberate form of protectionism in which domestic competitors are able to sell products while foreign competitors are delayed in the notification process, it could, in any case, result in individual competitors being frustrated and retreating from the respective market. This is a cost in terms of dynamic competition with the impact of competitive forces being reduced[39].

Table 5 below presents the estimated time requirements of going through the regulatory authorities. It is striking that the maximum period of two months for notification as stated in the Directive seems to be rather the rule. CRA (2006) interviewees even argued that this time limit results in a minimum time for the regulator to respond with a request for more information but did not guarantee the length of the notification process in some Member States. Given that the notification procedure comprises much less issues than the authorisation process, it is surprising that in many Member States (in italics) notification often takes longer than the authorisation.

Table 5: Time taken to get regulatory approval

Member state	Fund authorisation	Fund notification
Belgium	1-2 weeks	2 months
France	4 weeks on average	8 weeks but occasionally up to 6 months
Germany	3 weeks	8 weeks
Ireland	6-8 weeks on average	2 weeks
Italy	prospectus 20 days, fund rules 40 days	2 months but up to 16 weeks
Luxembourg	2-8 weeks depending on the file	8 weeks
Poland	5-6 months	2 months
Spain	Typically 1 month, but up to 2 months	Typically 1 month, but up to 2 months
Sweden	3 months, 6 months for complex fund	4 weeks sometimes but usually 2 months
UK	6 weeks	2 months

Source: CRA (2006) based on interviews with fund managers and regulators.

It has to be noted that the CRA study signalled a positive trend in terms of greater speed of notification. The recently adopted CESR guidelines, however, are not seen as an effective instrument to cut down on the notification delays by some of industry. At the same time, a reduction in the time to market is not expected to reduce the cost differences in the regulatory compliance of the fund between member states. Instead its main impact seems likely to come through intensified competition between funds which are able to access markets more easily.

Cost of notification

[39] Although information was provided regarding the time authorisation and notification take on average, quantifying the impact of this time cost has not been possible.

Notification fees in different member states are provided in Table below. They are frequently the same as the cost of authorisation. This is a surprising finding as the tasks of the host regulator should be less demanding than the activities of the home regulator. Exceptions to this are Ireland, where no notification fees are charged, and France, where the cost of authorisation is based on the value of the fund whereas the cost of notification is a fixed fee and should be much lower for all but very small funds.

According to CRA, the cost of notification in terms of internal resources and use of external lawyers often accounts for less than 0.25 basis points for the largest providers. Even taking into account that regulatory costs are not one-off but might be charged again (though amounts might differ) every time changes are made to the fund[40] does not change this result fundamentally.

Despite the small figure of total costs of authorisation and notification, regulatory processes were nonetheless one of the key areas where fund managers have expressed most concern in the interviews conducted by CRA. Fund managers regarded the differences between member states in respect of notification as one area where cost savings could be achieved relatively easily and rapidly[41].

As well as the direct regulatory costs, the process of notification also imposes costs regarding the provision of information to the host authorities. As the notification process is regulated in the UCITS Directive, these additional costs should be similar across Member States. However, according to a report by EFAMA/IMA, [42] many countries impose additional information obligations to those required by the UCITS Directive.

This results in additional costs such as the use of local legal support and translation of marketing documents. In some cases there is a need for local representation. Further, many countries also require a special addendum[43]. In fact, according to the EFAMA/IMA report, only the UK imposed no additional requirements to those under the UCITS Directives.

It has to be noted that some of these requirements might stem from national marketing rules and present as such no infringement of the Directive. Furthermore, some of the above concerns will, at least partially, soon be dealt with by CESR notification guidelines issued in June 2006.

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40 Irish interviewees suggested that this could happen up to three times a year. This is broadly consistent with the statistics presented by EFAMA / IMA which estimated that pan-European providers have cost of approximately € 0.5 million per year to maintain registration.

41 Many fund managers have argued that the notification process is a purely duplicative cost that brings no benefit and that these costs could be stripped out of the value chain with no detrimental effect.

42 *A Harmonised, Simplified Approach to UCITS Registration*, EFAMA and IMA, April 2005.

43 This includes Austria; Belgium; France; Greece; Luxembourg; the Netherlands; and Sweden. Three of the largest markets impose requirements for new sub-fund notifications: France requires the certification of accuracy of information contained in the prospectus to be signed by two directors; Germany requires letters from paying agents and information agents confirming roles as well as proof of payment of initial registration fee; Spain requires a letter to the Spanish regulator signed by a director confirming documentation complies with the Spanish regulators requirements.

Table 6: Cost of notification

Direct cost imposed by regulators			
Member State	***Single fund***	***Umbrella fund***	***Frequency of payment***
Belgium	€0.075 per thousand assets under management plus €0.50 per thousand new subscriptions; for money market funds the cost is €0.05 per thousand net asset value with a minimum of €314.	same	Annual
France	€1,000	€1,000 per sub-fund	Annual
Germany	€1,500	€1,500 per sub-fund	Annual but only €500 per sub-fund
Ireland	No fees are charged	No fees are charged	No fees are charged
Italy	€1,400	€1,400	Annual
Luxembourg	€2,650	€5,000	Annual – part 1 fund incurs annual cost of €2,650; part 2 fund of €3,950; and umbrella of €5,000
Poland	€4,000	€4,500 for umbrella no additional costs for additions of sub-funds	One-off
Spain	0.014% of estimated sales with range of €975-39,033 for fixed income and €1,626-65,055 for variable income	same	Applied one-off or as long as the estimated sales increase
Sweden	SEK 5,000 (€540)	same	Annual
UK	£600 (€870)	£1,200 (€1,735)	Annual fee varies according to the number of sub-funds and varies from £620 - 13,640 (€900 -19,720)

Source: CRA (2006) based on interviews with, and data from, regulators and fund managers.

Objectives

The specific objectives here are the elimination of barriers to the integration of the European fund market and efficiency gains, ideally passed on to investors. This should result in increased competition among UCITS and improved competitiveness of UCITS vis-à-vis other investment products.

The operational objective is to make the notification procedure as cheap, easy and fast as possible without compromising effective supervision and investor protection. Notification should not take longer nor be more expensive than authorisation.

Overall, this measure should lead to a downward harmonisation in terms of costs and time for notification.

Description of options

i. Do nothing

Current problems persist, leaving investors with high costs and restricted choice. There is a risk that investors turn towards other, less regulated and more risky investment products. Industry would face (unnecessarily) high costs and slow access to markets resulting in a competitive disadvantage vis-à-vis other investment funds.

ii. Amendment of the UCITS Directive

An amendment to the Directive could comprise the following elements:

- set the maximum time spans for notification by national authorities;
- specify translation needs, i.e. when and which documents need to be translated;
- specify the necessary documentation a host country authority can request;
- change the procedure into a regulator-to-regulator notification;
- clarify the role of host country authorities in the whole procedure;
- promote the use of the most efficient communication channels

The amendment of the Directive would clearly state what requirements by the national regulators were acceptable and what not. Since notification would be indeed only notification in the narrow sense fees should be much lower if not completely abolished. Notification should take place on a regulator to regulator basis in order to avoid any pressure being exercised on fund managers by host authorities.

Time limits could be set in accordance to other legislation regulating similar issues. An example could be the model provided by the Prospectus Directive. This Directive requires that the home authority provides within three days of an authorised UCITS request the relevant host country authority with a certificate that the UCITS product is authorised. This could be done electronically using links to the relevant documents on the home authority's website where appropriate. The home authority would be to notify the UCITS provider immediately, once the notification to the host authority had been undertaken. Besides the acknowledgement of receipt, the host Member State authority would not have an immediate role in the notification process.

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

iii. Close monitoring and support of CESR work

CESR has adopted notification guidelines in June 2006 which need now to be implemented. The Commission would support this process and the development of best practices between Member States. Any further work at this level would be restricted by the basic parameters of the notification mechanism as stipulated in the Directive (2 month period, documentation channels for notification, etc.).

Close monitoring of the impacts of implementation of MiFID on UCITS markets, of the CESR guidelines and of the application of the notification provisions in Member States could provide the Commission, regulators and market players with useful information on the basis of which further initiatives could be developed if regarded as appropriate and necessary.

iv. Introduction of a Service Passport

This option would replace the current product authorisation by a collective investment scheme service passport for the operator of the UCITS scheme. Once an operator has been authorised it could issue funds via a self-authorisation process. This option would eliminate any regulatory delay in the marketing of new or altered funds both at domestic and at foreign markets. It would make the notification procedure obsolete. Therefore, it would represent the most radical solution in terms of reduced product-related compliance costs. Without product authorisation, investor protection would be ensured via the initial check of the service provider and in the distribution via MiFID rules.

Impact assessment

i. Do nothing

If no action is taken the current problems would persist. In the medium to long term there is a risk that both fund promoters and investors increasingly turn to non-UCITS. Contrary to regulators' aims, risks borne by retail investors would even increase, in some cases probably involuntarily.

ii. Amendment of the UCITS Directive

Assuming that the proposed changes were properly and implemented in a harmonised way, these amendments could lead to considerable reduction in the administrative burden on fund promoters of for pan-European funds. Although no immediate cost reductions could be envisaged for investors, a resulting increase in competition and improved competitiveness of UCITS products could create benefits for CIS. These combined effects should then provide investors with a better choice among domestic and cross-border state of the art products.

The net impact on the resources of national regulators can not easily be assessed. On the one hand, shorter time might require more staff, on the other hand, requirements regarding notification should be lowered in most Member States and industry might use notification much more often than before as it becomes much more attractive. Therefore, some authorisation work would be replaced by –less labour-intensive– notifications. In the end, work might be redistributed across Member States with only a marginal net effect.

It has to be noted that the legislative process would not allow for changes taking effect within less than three years at best.

iii. Close monitoring and support of CESR work

CESR work could potentially produce effective solutions within a short period of time. Improved cooperation mechanisms should help to overcome alleged distrust among authorities. This could help achieving the above objectives to a varying degree and prevent any suspicion that the regulatory process was being used as a form of protectionism. Yet, as CESR work has broadly exhausted its limits, no significant immediate impacts are to be expected.

iv. Introduction of a Service Passport

The introduction of a service passport would mean a fundamental disruption in the approach and "philosophy" of the UCITS Directive. It would represent a deviation from the "product approach" of the Directive and thereby provoke a series of knock-on effects. Besides posing several legal problems, it would have a considerable impact on the perception of the UCITS brand and would put more stress on MiFID than was originally foreseen. Furthermore, it would put an end to the regulatory stamp of approval for UCITS products. This product approval, however, is at the core of the UCITS brand which assists operators to sell the UCITS product outside the EU. The detailed consequences of such a re-write for investors and markets are hard to foresee, given that MIFID itself is still in the process of being implemented.

It can not be ruled out that self-authorisation of products could lead to lengthy and fierce disputes between fund promoters and regulators about eligibility issues at domestic and cross-border level with delays in procedures.

Comparison of options

Following option i would ignore the opportunity that the likely amendment of the Directive in other areas would provide. It would leave the industry with heavy administrative burden which are hardly justified by the potential benefits.

Option ii would not provide quick solutions. But as it is not an extremely urgent measure, this would not be a major shortcoming. It could be expected that the proposed changes lead to more competition in and competitiveness of the industry, while ensuring the same level of investor protection as under the current regime.

The effects of option iii would be too minor and uncertain. There would be a major risk that the situation would not improve much and that the above mentioned opportunity would be missed.

On the one hand, the service passport might ultimately result in faster time to market but that benefit would not be significant option ii was implemented. On the other hand, option iv could put the whole industry in danger by "destroying" the UCITS brand and the product passport, the feature which most prominently distinguishes UCITS from other investment products. As a result, the expected net benefit might even be negative compared to the status quo and certainly lower than that of the other options.

In conclusion, option ii seems to be the most advantageous one when all aspects, especially the likelihood of achieving the expected results, are taken into account.

Table 7: Overview of impacts

	Option	Enhance market efficiency	Maintain high levels of investor protection	Observations
1	Do nothing	≈ -	≈ -	Current problems persist
2	Amendment of the Directive	≈ +	≈ +	More comprehensive and "tailor-made" for UCITS than option 5
3	CESR work	≈	≈	Uncertain outcome in terms of substance and timing
4	Service passport	≈ +/- ?	≈ -	Severe interference with the "UCITS philosophy"

Table 8: Impacts

Option	Affected parties Directly: D Indirectly: I	Impacts Positive: +. Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Timing One-off, Short-, Mid-, Long-term **Nature:** Dynamic - Static	Likelihood Certain High Medium Low	Remarks
1. Do nothing	Industry: D	≈/- long and cumbersome procedures ≈/- high costs ≈/- negative impact on market integration and efficiency	Permanent Dynamic		
	Investors: I	≈/- less choice/later access	Permanent		
	Authorities D	In some cases inefficient procedures			
2. Amend Directive	Industry: D	≈/+ faster and easier procedures ≈/+ improved competitiveness	mid/long-term	Medium	
	Investors: I	≈/+ more choice between competitive up-to-date products	mid/long-term	Medium	
	Authorities D	≈ adjustment of procedures ≈ staff implications	One-off Mid/long-term; static	Medium	
3. CESR work	Industry: D Investors: I Authorities D	In principle similar to option 2 but outcome less certain and risk of less harmonised implementation; therefore benefits might be reduced considerably.	Mid-term	Low	
4. Service passport	Industry: D	≈/+ fast access to market for new product - risking positive UCITS brand image	mid-term; dynamic	Medium	
	Investors: I	≈/+ more choice between competitive up-to-date products - increased product risks	Mid-term; dynamic	Medium	
	Authorities D	≈ switch from product to service approval	long-term; static	Medium	

Fund mergers

Definition:

The merger, consolidation, or purchase or sale of substantially all of the net assets between an investment fund (or a series thereof) and another investment fund. A domestic merger is a

merger between two or more funds domiciled in the same Member State. A cross-border merger is a merger between funds that are domiciled in different Member States.

Problem description

The consequences of the proliferation of funds of sub-optimal size have been often stressed during the on-going debate on the efficiency of the fund market: large and complex fund ranges create confusion among investors preventing the exploitation of economies of scale. However, fund proliferation is set to continue. Fund launches remain the preferred strategy for asset managers to innovate, raise new assets and respond to new investors' needs or preferences[44]. According to Feri data, 2.694 new funds (representing some 10% of the total number of funds) were launched in 2005. This compares with the 1.807 fund mergers and closures reported that same year. The total net increase (887 funds) contrasts with the reduction of 65 funds accounted for in the American fund market during the same year.

Some studies have tried to assess and quantify the missed opportunities. The so called "Heinemann report" estimated that € 5 bn could be saved annually if the European average fund size would converge to that of an American mutual fund[45]. In 2005, an Invesco report considered that European investors were charged an estimated € 2-6 bn in annual fees more than they would if scale economies could be fully exploited[46]. TERs of actively managed funds domiciled in Luxembourg considerably diminishes with the size of the fund[47]. More recently CRA has estimated that annual savings of up to 17 bp could be attained if European equity fund sizes would converge to that of the average US fund[48].

What impedes funds from merging and increasing their size? Fund mergers do take place at national and, to a lesser extent, at a pan-European level (please see table below). Merging activity at the national level has been intense during the last years [49], often prompted by the merger of banking groups. Difficulties encountered habitually relate to regulatory requirements such as the need for the investment policies to be identical or high levels of shareholder consent (e.g. in some countries 100% of shareholder approval is requested). However, the hurdles to cross-border mergers are far more challenging. From a legal point of view, the absence of a common EU framework leads to the coexistence of different national approaches and rules. This renders cross-border mergers expensive, complex and time consuming when at all possible. Uncertainty regarding the outcome and important delays discourage industry players. The existence of different national approaches may distort economic outcomes by forcing industry to merge into domiciles not because it makes sense from a business point of view but simply because it is easier. From a fiscal point of view, while many EU Member States have introduced measures to enable domestic fund mergers to

[44] An investment fund is said to have a commercial life of three years (after which fairly no sales take place).

[45] "Towards a single European market in asset management", ZEW, May 2003.

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

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

[48] "Potential cost savings in a fully integrated European investment fund market", CRA, August 2006. Study based on a sample of European countries representing 90 % of the UCITS market (referred as CRA report in further sections).

[49] In its contribution to the Commission's Green Paper on investment funds, AFG reported that around 600 fund mergers had taken place in France since 2003.

take place in a tax-efficient manner[50], a cross-border merger is often considered a taxable event[51].. This is considered by the industry as an important disincentive which clearly limits further consolidation[52]. A Global survey conducted by PwC in 2006 shows that only 4% of the interviewed Chief Executives indicated 'rationalisation of the product range' as a key objective of their business. The main cited challenges to rationalisation were the cost of implementation (25%), achieving investor approval (23%) and obtaining regulatory approval (23%)[53].

Table 9: Fund mergers in the EU

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

Source: Feri FundFile

The existence of ever growing fund ranges creates confusion among distributors and investors rendering choice more difficult. It can also increase the complexity of managing them and thus require more investment in time, means and/or human resources at different levels of the industry value-chain.

Table 10: Problem table

Which is the problem? (*reasons)	What are the consequences?
Difficulties with cross-border mergers of funds * absence of EU framework (Regulatory) * adverse taxation implications (Taxes)	Proliferation of (small) funds ⇒ unexploited scale economies → higher costs ⇒ complex fund ranges → difficult choice → higher costs

Objectives

General objectives:

- Enhance the fund market efficiency
- Maintain high levels of investor protection

Specific objectives:

- encourage cost savings
- promote the rationalisation of the fund landscape

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

[51] Investment fund mergers are not covered by the "Taxation of mergers" Directive (Council Directive 90/434/EEC of 23rd July 1990)

[52] Expert Group report to the European Commission on Investment Fund Market Efficiency (referred as report on IFME in the rest of the analysis), July 2006.

[53] "Global Investment Management Survey 2006: shaping the future", PricewaterhouseCoopers

- ensure that investors are fully informed of the implications and have the right to vote against the merger
- enhance the cooperation between regulators for overseeing mergers and ensuring that they take place in a way that is consistent with investor protection.

Description of options

Regarding regulatory barriers

i. Amend the UCITS Directive to remove regulatory and legal barriers to fund mergers. This would imply not only recognising the possibility for UCITS to merge (including the modalities that this could take), but also introducing a series of regulatory accompanying measures to maintain investor protection and allow effective supervisory oversight. Thus, provisions regarding investor information and rights, supervisors' respective responsibilities and valuation requirements will need to be clarified[54].

ii. Support a convergence of national approaches. This could be done with the adoption of a Recommendation or encouraging CESR to develop guidelines on fund mergers[55]

iii. Do nothing

Regarding taxation barriers

iv. Adopt a "Taxation of fund mergers" Directive. In addition to option i., a parallel directive on the taxation of mergers of funds would be introduced to ensure that these mergers do not give rise to any (adverse) tax implications. Alternatively, the "Tax Merger" Directive[56] could be amended in order to include UCITS.

v. Communication on the discriminatory tax treatment of cross-border mergers. A communication would clarify whether/when applying different conditions to cross-border mergers than those to national ones would be considered as discriminatory.

vi. Do nothing

Impact assessment

Regarding regulatory barriers

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54 Another possible option is the adoption of a new Directive on fund mergers. However, while presenting similar benefits and drawbacks to the amending the UCITS Directive option, it was not considered to offer additional advantages. Also it could be even a more burdensome solution if changes to the Directive would have to be done in any case respect to other of the issues analysed in this report. In order to keep the analysis simple, it has been therefore decided not to focus on this option.

55 Other possibilities put forward by stakeholders are bilateral discussion among Member States to facilitate cross-border mergers among funds in their jurisdiction or a more positive interpretation of national rules (see for example ALFI, DFIA and IMA's responses to the report on IFME and Invesco's report on 'Building an Integrated European Fund Management Industry' [October 2006]). However, these solutions fall under the remit of Member States.

56 Council Directive 90/434/EEC of 23rd July 1990 as last amended by Council Directive 2005/19/EC of 17 February 2005.

i. Amend the UCITS Directive

Changes to the directive as described above will need to be introduced at four levels. First, at the definition's level, i.e. what constitutes a merger of funds. Second, regarding the operational details: similarity of investment policies, valuation of assets, track record, fund naming, who bears the costs… Third, clarifying the respective roles and responsibilities of the regulators involved. Finally, introducing provisions ensuring investors' protection. These would include a complete information on the mergers, the need for unitholder approval and the possibility for the unitholder to redeem free of charge in advance of the merger[57]. (Other issues might arise in the context of the preparation of amendments.)

However, before analysing the implications of such changes, it appears necessary to determine whether the new framework would apply only to cross-border mergers or also to national mergers as requested by several industry representatives[58]. Extending an EU regime to national fund mergers may imply changing national rules to which domestic players are used. On the other hand, a broad scope will provide a homogenous level of protection to investors irrespective of the fact that their fund would be merging with another domestic fund or cross-border. Furthermore, a domestic fund merger can also have implications across borders as investors can be domiciled in another Member State[59]. It would therefore be advisable that the new fund mergers framework cover all mergers, domestic or cross-border.

The impacts of the new fund merger regime will vary depending on the stakeholder category considered.

Industry: The time, costs and uncertainty associated with cross-border mergers will be materially reduced. This would allow industry players to better organise their business on a pan-European level. They would also be able to achieve economies of scale and reduce managing costs. This cost savings will continue all over the life of the resulting fund and should compensate the one-off costs generated by the investor protection regulatory requirements (information disclosure, organisation of the unitholders' vote…) A facilitating fund merger framework would also produce dynamic effects since 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. Considering that net fund sales of European funds outside the EU represented in 2005 21 % of the total third-party sales, this is not a negligible argument[60].

Investors: The above regulatory requirements should guarantee that investors do not lose out from the merger. However, the extent to which investors will benefit from the cost savings generated would very much depend on the level of competition between asset managers and the relative power of distributors [61]. Thus, efficiencies gains may only be passed on to investors slowly[62]. It is also said that rationalised and therefore less confusing fund ranges

57 Issues highlighted in "An examination of the regulatory issues arising from CIS mergers", IOSCO, November 2004.

58 EFAMA and IMA contributions to the Green Paper consultation. Report on IFME.

59 Report on IFME.

60 Feri data (based on a sample of financial groups representing 70% of the cross-border business).

61 Please see Oxera report on the shift in bargaining power down the value chain. Also Funds Europe (August 2006) cites the concentration of power in the hands of distributors as an "unforeseen consequence" of the move towards open and guided architecture.

62 CRA report.

should facilitate the choice of investors. However, this effect is not so straightforward given the growing complexity of the product itself.

Authorities: The direct implication for regulators (and other relevant parties) of the new framework will be the required time and efforts first to agree and then to implement the changes to the Directive. This implementation could be more complex and burdensome when other areas of national legislation, such as corporate law, need to be adjusted. Also cooperation mechanisms will need to be developed to give confidence in the way in which mergers will take place. The time and resources' costs of implementing the changes could be considered as one-off (and therefore more quickly outweighed by the long-term cost savings achieved by mergers). On the other hand, the new framework would increase the number of mergers (particularly cross-border) and, thus, possibly the on-going workload of national regulators. However, relying on a common framework may streamline the process (please see below).

This option is compatible with the introduction of a Lamfalussy approach, i.e. focus on the principles and investor protection requirements of fund mergers when changing the Directive (Level 1) and specify the details at further levels.

ii. Support a convergence of national approaches.

Greater convergence of the different national approaches to fund mergers will facilitate cross-border ones. It will also foster the development of national legislation in those countries where a regulatory framework for mergers does not exist yet. However, cross-border mergers may still need to be dealt with in a case by case basis implying a high involvement of the regulators concerned as well as an important investment in time and human resources on the side of the industry. Costs, uncertainty and delays will thus be only slightly reduced.

Concerning the instrument chosen (Recommendation or CESR guidelines), their non-binding nature is the main drawback. Divergent implementation will undermine the impact of the measures. Besides, in the case of the guidelines, the outcome will depend on the willingness of CESR to work on this issue and the ability of its members to reach an agreement. There is therefore the risk that efforts invested in the drafting and implementation of the Recommendation/CESR guidelines would not be rewarded.

iii. Do nothing

In the absence of any facilitating option, the problems detailed above will persist. Continued fund launches and further consolidation between financial groups are likely to accentuate them even more.

At the industry level, the merging activity will probably continue but at a slow pace, restraining the reorganisation of the industry. Over the long run, the proliferation of funds would possibly increase the costs of managing ever wider and more complex fund ranges. Operational errors may also be more likely. Beyond EU borders, the ability to conquer other markets will be curtailed, limiting the development of the EU industry. For the investors, the status quo will mean higher costs and/or lower performances. It will also mean that they may be deficiently protected in the event of a cross-border merger or a national merger of funds in another Member State. On the side of the authorities, the absence of a common framework would mean that approval of cross-border mergers would be often done on a case by case basis and/or would require time consuming interaction between the regulators concerned.

Regarding taxation barriers

iv. Taxation of fund mergers" Directive

A tax-neutral regime for fund mergers, concerning the taxation of the funds as well as of their unitholders in the case of fiscally transparent funds, is necessary to secure the benefits associated with mergers. It should also accelerate the rhythm of consolidation and thus the achievement of efficiency savings. The direction of the impacts of this option will be similar to the previous one. Investors would benefit more directly since mergers are often treated as a transfer of assets that triggers capital gains which are subject to taxation.

However, in this case, an important consideration is the feasibility. Adopting a Directive in the fiscal area can be challenging since unanimity among Member States is required. Given the increasing number of Member States, this can be a long process with no guarantee of success.

As an alternative, the "Tax Merger" Directive could be amended in order to include UCITS. However, while this will still require unanimity, it would also be a partial solution since it applies only to companies subject to corporate taxation. UCITS of a contractual type (and some corporate ones) will therefore remain uncovered.

v. Communication

The objective of such a Communication would be to avoid a discriminatory tax treatment between national and cross-border mergers. Its rationale would follow that of the judgement of the European Court of Justice on the so called SEVIC case on Company Law for corporate mergers[63]. On this basis, when a tax-neutral regime exists for domestic mergers, the application of a discriminatory tax treatment to a cross-border merger could be considered as a restriction to the fundamental principle of freedom of establishment contained in the Treaty. Also more recent ECJ jurisprudence would indicate that while a Member State has a right to tax gains accrued within its territory, this may take place only when the gains are realised[64].

Issuing a Communication would require far less time and resources than the adoption of a Directive. However, its impact may be lesser given its non binding character. It should be also noted that the concrete implications for cross-border mergers of funds of the above mentioned ECJ judgements are still subject to further analysis by Commission services.

vi. Do nothing

As explained above, the tax treatment of fund mergers can be a real deterrent. Without measures to prevent that fund mergers be considered a taxable event, the mere logic of the merger could be put into question. Investors will be penalised. Adverse tax repercussions could outweigh efficiency gains.

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63 Case C-411/03 of 13th December 2005.

64 Case C-470/04 (N v Inspecteur van de Belastingdienst Oost) of 7th September 2006.

Comparison of options

The assessment of the options has been done taking into account the ability to attain the objectives defined above. The result is summarised in the following table and explained below.

Table 11: Overview of Impacts

Barrier	Option	Enhance market efficiency	Maintain high levels of investor protection	Observations
Regulatory	Amend UCITS Directive	++	+	Most effective
	Soft law	?	+	Doubtful effectiveness
	Do nothing	--	-	High opportunity costs
Taxation	Taxation Directive	+	+	Low feasibility
	Communicatio n	?	+	Most cost-effective
	Do nothing	--	-	High opportunity costs

The 'do nothing' option is not the optimal solution. It would prevent important cost savings that should, in the medium term, be passed on to investors. An assisting framework for fund mergers is therefore necessary. At the level of the mechanism it self, soft law solutions risk to be ineffective. At the level of the tax implications, embarking in the adoption of a Directive would require important efforts (with no security of success). Thus, the preferred option is a combination of options i. and v, that is, amending the Directive to facilitate cross-border mergers and issue a Communication relative to the taxation of fund mergers.

Table 12: Impacts

Option **Regulation**	**Affected parties**	**Effect** Direct: D Indirect: I	**Impacts** Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	**Impact Timing** One-off Short-term Medium-term Long-term	**Impact Nature** Dynamic Static	**Impact Likelihood** Certain High Medium Low
Amend UCITS Directive	Industry	D	+ ↑ flexibility for x-border business ++ ↑ efficiency + ↑ global competitiveness	medium-term	dynamic	high
	Investors	I	≈ facilitated choice + lower costs	long-term	static	medium
	Authorities	D	- efforts to agree & implement changes	one-off	static	certain
			- ↑ workload	long-term		low
Soft law	Industry	D	+ ↑ flexibility for x-border business + ↑ efficiency + ↑ global competitiveness	medium-term	dynamic	low
	Investors	I	≈ facilitated choice + lower costs	long-term	static	low
	Authorities	D	- efforts to agree / implement changes	one-off	static	certain
Do nothing	Industry	D	- less flexibility for x-border business -- less efficiency - less global competitiveness	short-term	dynamic	certain
	Investors	D	- less protection	medium-term	static	low
			≈ complex choice -- higher costs	short-term		certain
	Authorities	D	- more workload	medium-term	static	medium

Option **Taxation**	**Affected parties**	**Effect** Direct: D Indirect: I	**Impacts** Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	**Impact Timing** One-off Short-term Medium-term Long-term	**Impact Nature** Dynamic Static	**Impact Likelihood** Certain High Medium Low
Taxation Directive	Industry	D	+ ↑ flexibility for x-border business + ↑ efficiency + ↑ global competitiveness	medium-term	dynamic	high
	Investors	D	+ lower costs	medium-term	static	high
	Authorities	D	-- efforts to agree & implement changes	one-off	static	certain
Interpretative Communi-cation	Industry	D	+ ↑ flexibility for x-border business + ↑ efficiency + ↑ global competitiveness	medium-term	dynamic	medium
	Investors	I	+ lower costs	medium-term	static	medium
	Authorities	D	- implementation efforts	medium-term	static	certain
Do nothing	Industry	D	- less flexibility for x-border business -- less efficiency - less global competitiveness	short-term	dynamic	certain
	Investors	D	-- higher costs	short-term	static	certain

Asset pooling

Definition:

Asset pooling implies the ability to combine asset into a common account for the purpose of investment management and custody. There are basically two pooling techniques:

Entity pooling uses legal entities to undertake pooling. There are two forms of pools which can be used for this purpose, "opaque" pools or "transparent pools." An opaque pool has a separate legal personality of its own. The participating funds are the owners of units in the pool which in turn is the legal and beneficial owner of an underlying portfolio of assets. In contrast to opaque pools, a transparent pool has no legal personality of its own. Participating funds remain the legal and beneficial owners of the underlying portfolio of securities. In "master-feeder" structures the pool is called the "master" and the participating funds "feeders".

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

Problem description

Fund proliferation as explained above adds a heavy burden on the fund industry and ultimately investors. However, mergers are neither the only route to achieve economies of scale nor the optimal one in certain business cases. Local presence may be favoured in some markets in order to better adapt fund features to investors' preferences (e.g. charging

structure). In that case asset pooling would provide a more appropriate solution. Pooling also facilitates product innovation and a manager of managers' approach since it allows leveraging the know-how of a set of specialised fund managers[65].

Pooling[66] have been widely used in some EU jurisdictions but limited to funds in the same domicile. However, to better exploit potential scale economies pooling on a cross-border basis would be necessary.

Obstacles to cross-border pooling in the UCITS framework can be of a legal, regulatory, technical and fiscal nature. Some of them are motivated by the perceived risk that such techniques entail (e.g. circumvention of UCITS investment restrictions), others stem from the development of different national regimes (e.g. in the areas of taxation and accounting). Concerns about split supervision also explain national authorities' reluctance to cross-border pooling. As regards to the concrete pooling techniques, the obstacles differ in nature.

Virtual pooling structures are not prohibited by the UCITS Directive. They are nevertheless regarded as complex and requiring important investment in IT systems. The requirement that the depositary is based in the same domicile than the fund can also be an obstacle if the assets safe-keeping can not be delegated across borders[67].

Entity pooling is easier to implement in terms of clarity of the legal requirements, custody, etc. and to supervise. However, it is prevented by the UCITS Directive's diversification requirements. Besides, withholding tax on the distribution of underlying investments can have a negative impact if the entity pooling the assets is not fiscally transparent[68]. The table below summarises the main barriers to both types of pooling[69].

Table 13: Problem table

Which is the problem? (*reasons)	What are the consequences?
Barriers to asset pooling a) Virtual pooling * delegation of custody cross-border not always allowed (Regulatory) * lack of common understanding among regulators (Others) b) Entity pooling * Directive rules it out (Regulatory) * possible adverse taxation (Taxes)	Need to manage individually a high number of funds of a small size ⇒ unexploited scale economies → higher costs

Objectives

General objectives:

- Enhance the fund market efficiency
- Maintain high levels of investor protection

65 FEAM response to the Green Paper consultation, 31st October 2005.
66 For a description of the different pooling techniques please see the Appendices to the report on IFME.
67 This issue will be dealt with on the depositary section below.
68 "Pooling: how can fund managers respond efficiently to different investors needs?", IMA, July 2005.
69 Extracted from the report on IFME.

Specific objectives:

- encourage cost savings
- ensure that investors' interests are not compromised when they invest in funds whose assets are pooled
- enhance the cooperation between regulators

Description of options

Entity pooling

i. Amend the Directive to allow entity pooling in a broad sense: This means giving the possibility for a feeder-fund to invest in one or more master-funds. This option does not simply entail changing the investment limits set by Article 24. In order to maintain adequate investors' protection levels it would be essential to include provisions aiming to clarify supervisors' respective roles, define some necessary features of the pooled structures and require the disclosure of the relevant information to investors.

ii. Amend the Directive to allow only master-feeders structures: This will be similar to the previous option; however, feeder-funds will be allowed to invest in an only master-fund. Again, the technical provisions will have to be completed by investor protection requirements.

iii. Do nothing

Virtual pooling

i. Amend the Directive to allow virtual pooling: This would not only imply recognising the possibility for UCITS to pool virtually their assets. In order to overcome potential supervisory and investor protection concerns, it will be important to define concrete aspects of the working of the pooling structure.

ii. Encourage CESR to develop guidelines on virtual pooling. These could be done in collaboration with CEIOPS since investment funds' and pension funds' pooling share many features (and obstacles).

iii. Do nothing

Impact assessment

Entity pooling

i. Amend the Directive to allow entity pooling in a broad

As explained above, changes to the Directive will have to address also the risks and concerns associated with this pooling technique. The requirement that masters and feeders would be

UCITS could soften some split supervision concerns[70]. Mechanisms to reinforce the cooperation among supervisors will also have to be put in place. Appropriate provisions regarding the disclosure of information to investors about the fees of the pooling structure, as well as, on fee arrangements between masters and feeders should also be added[71].

As with fund mergers, taxation can be an issue in certain cases (opaque pools). However, the tax repercussions may be more modest than in the case of mergers. First, the main problem is withholding tax which penalise income and interest received and not capital gains that can be more substantial. Second, it is only relevant for some pooled entities[72]. Therefore, the tax dimension will not be analysed in what follows. Notwithstanding, investors should be fully informed of the potential tax implications (e.g. in terms of lower returns) that the use of this pooling technique may entail.

The potential impacts of this option are as follows.

Industry: Economies of scale will lead to cost savings at different levels of the fund value chain. At the front-office, the number of different portfolios to deal with could be reduced. The amount of assets that only one fund manager would be able to manage will increase. Managers related overheads as a proportion of assets will then decrease[73]. At the back-office level, less transactions at higher average volumes sizes, fewer trading accounts, better execution prices, as well as, lower and degressive service-provider (e.g. custodians) fee schedules are examples of scale opportunities[74] . Savings at both levels are said to largely compensate the costs of setting entity pooling structures which have been estimated to lie in the range of 1 to 3 basis points[75]. Reduction of the number of portfolios/ account to manage should also reduce operational risks[76]. The gain in efficiency achieved would allow the industry to increase its competitiveness on a global scale. Finally, the use of this pooling technique would also facilitate product innovation allowing the industry to adapt better and quicker its products to investors' demand. Greater competitiveness and product innovation may have dynamic effects since they would attract higher volumes and thus foster further economies of scale.

Investors: Some of the benefits of pooling are said to flow directly to investors. In particular when they translate into lower costs for the fund (and therefore potentially higher net returns for investors). For the rest the pass through to investors of cost savings accruing to the asset manager would, however, depend on the degree of competition among industry players. The extent of investor's gains would also be influenced by the charges policy of the product, particularly when the pooling structure implies a double layer of fees.

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[70] These concerns stem from the fact that investment decisions are taken by a master fund located in a different jurisdiction than the feeder funds. Investors on the feeder funds may not have the necessary protection since their national authorities have no direct legal means to take necessary action against a fund in another jurisdiction.

[71] Entity pooling structures may entail a double layer of fees. The investor will be then bearing directly the fees applied to the 'feeder 'and indirectly those applied to the 'master'.

[72] That is when the assets of participating funds do have tax treaty entitlement (please see the report mentioned in footnote 28).

[73] Investment managers consider that this front-office cost component alone could reach as much as ten basis points (Appendices to the report on IFME).

[74] Appendices to the report on IFME.

[75] Idem.

[76] Crédit Agricole Asset Management response to the Green Paper consultation.

Appropriate information on fees and potential risks to investors ahead of their investment decision should mitigate the repercussions of these potential shortcomings.

Authorities: The direct implication for regulators will be the required time and efforts first to agree and then translate into national legislation the Directive changes. One practical difficulty will be how to make the distinction between funds of funds and entity pooling so that the latter is not used to get round the diversification limits applicable to funds of funds. Requiring that masters and feeder-funds to belong to the same asset management group could help. Concerns relative to the circumvention of investment restrictions or to split supervision should be alleviated by the requirement that both masters and feeders would be UCITS and by the creation of a supervisors' cooperation mechanism in this area (e.g. information sharing and assistance agreement). The implementation of such a mechanism would increase supervisors' costs. However, it should benefit from cooperation structures already in place among supervisors.

This option is compatible with the introduction of a Lamfalussy approach. That will limit changes to the Directive to the strict minimum necessary leaving for levels 2 and 3 the operational details. It would also allow adapting the framework in line with the development of entity pooling techniques.

ii. Amend the Directive to allow only master-feeders structures.

Compared to entity pooling in a broad sense, master-feeders are less complex structures. However, similar provisions to mitigate supervisory and investor protection concerns would need to be introduced.

Allowing their use will have comparable impacts as for option i., although from the industry point of view the flexibility will be lower. For the investors, master-feeder structures will be more straightforward and easier to understand. For authorities, supervision and cooperation among the concerned authorities will be easier. Besides, the master-feeder technique is more transparent and better known[77]. Thus, their reluctance to authorise it should decrease.

This option is also compatible with the introduction of a Lamfalussy approach.

iii. Do nothing.

In the absence of any action in this area, the consequences are similar to those described for in the fund merger case. At the efficiency level, the possibility to exploit economies of scale will remain limited. As a result, investors will continue to bear unnecessarily high costs. The competitiveness of the European industry may also be at risk. The continuous launching of new funds will worsen the situation.

<u>Virtual pooling</u>

i. Amend the Directive to allow virtual pooling

Industry: Implications in terms of economies of scale at the front and back offices are similar to those described above. However, cost savings would differ vis-à-vis those achieved by

[77] A series of responses to the report on IFME seem to prefer master-feeder structures (e.g. see contributions from AFG, BVI, FEAM, French Treasury, EFAMA and the Irish regulator.

entity pooling. On one hand, virtual pooling does not require the existence of master funds (and thus authorisation and information disclosure costs associated to these do not exist). On the other, the complexity of virtual pooling structures, and its higher associated operational risks, may require greater monitoring capabilities and often important investment in IT. As in the case of entity pooling, potential efficiency gains will improve the industry competitiveness. It should also facilitate product innovation.

Investors: Advantages and disadvantages for investors are also similar to those of entity pooling option. However, an important feature of virtual pooling structures is the difficulty to segregate assets. This makes more difficult valuation processes, depositaries' monitoring and regulators' supervision. This could undermine investor protection. Lack of segregation of assets and interdependency of the funds mean that investment in one participating fund would have repercussions on the performance and costs for investors in other funds within the same structure[78]. Operational risks are also shared among participating funds. Finally, virtual pooling is less transparent and more difficult to understand. All this will require accompanying the amendments relating to the working of the structure with provisions aiming to maintain investment protection levels. These provisions could focus on the need to clearly disclose the advantages and drawbacks of the pooling structure, as well as on the IT and human capabilities of the management company and/or depositary.

Authorities: The complexity and opacity of virtual pooling seems to raise more supervisory concerns than entity pooling. Changes to the Directive to create an EU framework in that area would therefore require a certain investment in time and efforts to reach a common understanding. Technical and operational matters such as the clarification of the ownership of assets, disclosure requirements, measures to mitigate operational and joint-liability related risks, clarification of the respective responsibilities of the different players would need to be agreed upon. The corresponding provisions could be completed with the creation of a supervisors' cooperation mechanism (or extend the mandate of an existing one).

A possibility within this option would be to limit changes to the Directive (level 1) to key principles and characteristics of virtual pooling and to establish the basis to deal with the technicalities at level 2 (Lamfalussy approach). This would have the same implications for the industry and investors as those detailed above. However, this would not reduce the efforts on the authorities' side and, by adding a step, would probably take a longer time. On the other hand, it would add flexibility, allowing to adapt more quickly to innovations in the area of virtual pooling.

It remains to be seen to which extent there is a need to determine in detail how virtual pooling arrangements should work. Concentrating on the means/resources necessary to manage pooled structures could be a more proportionate solution. Another possibility in this respect would be to increase the safeguards imposing additional obligations or responsibilities on the management company or the depositary. However, this will not necessarily mitigate split supervision concerns.

ii. Encourage CESR to develop guidelines on virtual pooling.

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[78] AMF's response to the Green Paper consultation. Concerns in relation to the segregation of assets have also been expressed during the consultation on the report on IFME (e.g. see French Tresury and Czech Ministry of Finances' contributions).

Even if there is nothing that prevents virtual pooling in the UCITS Directive, the disadvantages and risks of virtual pooling explained above explain the reluctance of some national authorities to authorising its use. Others, however, have allowed it under certain conditions (e.g. among sub-funds in an umbrella structure). Their experience could serve as a basis for other Members States' reflection in this area.

Allowing virtual pooling within a Member State can have cross-border implications (e.g. if the pooled fund is offered for sale in other Member States). Divergent virtual pooling frameworks may also imply an uneven level of investor protection. National authorities may have then an interest to share views and eventually clarify certain virtual pooling related matters. This could take the form of CESR guidelines (which could be developed in collaboration with CEIOPS given that pooling is a technique also used by pension funds).

Pursuing this route would facilitate the implementation of virtual pooling and foster economies of scale related savings. However, it would very much depend on the willingness of CESR to work on this issue and the ability of its members to reach an agreement. In addition, the resulting guidelines would be of a non-binding nature. Their implementation and enforcement are thus not warranted.

iii. Do nothing

Similar effects as those explained in respect of the third entity pooling option are anticipated.

Comparison of options

Doing nothing would maintain a situation of high costs for investors and restricted opportunities for the industry. It is, therefore, not the optimal solution for either entity or virtual pooling. However, compared to fund mergers, the scope to exploit economies of scale through pooling is lower. Since the number of funds is not reduced, associated costs such as notification, documentation, accounts, etc. remain[79]. Important supervisory and investor protection concerns need to be addressed. Justification to proceed with time consuming and costly changes (in terms of efforts for all players involved) seems therefore weaker.

In the case of entity pooling (particularly master-feeders), there is a clearer understanding of the Directive changes needed. Supervisory and investor protection concerns are lower and easier to mitigate than for virtual pooling. Time and efforts invested should be therefore contained. Given the potential for higher net returns for investors, changing the Directive to allow entity pooling appears a sensible option. The question remains what should be the scope of this new freedom. In the case of master-feeders structures, there is a greater acceptation and broader experience. However, a preliminary analysis indicates that it is possible to mitigate the identified drawbacks of entity pooling in a broad sense (please see above). Given the additional flexibility that entity pooling in a broad sense offers, it seems to be worth trying it as a first option.

In the case of virtual pooling, the conclusion is less straightforward. Regarding the amendment of the Directive (option i.), detailed provisions would have to be introduced in order to overcome potential risks to investor protection. The efforts and involvement of all concerned parties is deemed to be greater. As regards to CESR guidelines on virtual pooling (option ii.), their effectiveness to foster efficiency gains is uncertain. Thus, for the sake of

[79] FEAM response to the Green Paper consultation.

effectiveness, the preferred option is amending the Directive. However, CESR guidelines could be pursued as a 'second best' (or eventually as a complementary) option, particularly if discussions on the Directive amendments with Member States prove unfruitful.

Table 14: Overview of Impacts

Technique	Option	Enhance market efficiency	Maintain high levels of investor protection	Observations
Entity Pooling	Amend Directive to allow EP	++	+	Cost-effective, more flexibility
	Amend Directive to allow master-feeders	+	+	Cost-effective
	Do nothing	--	-	High opportunity costs
Virtual Pooling	Amend Directive to allow VP	+	+	Less support
	CESR to develop guidelines on VP	?	+	Effectiveness doubtful
	Do nothing	--	-	High opportunity costs

Table 15: Impacts

Option **Entity Pooling**	Affected parties	Effect Direct: D Indirect: I	Impacts Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Impact Timing One-off Short-term Medium-term Long-term	Impact Nature Dynamic Static	Impact Likelihood Certain High Medium Low
Amend UCITS Directive to allow entity pooling in a broad sense	Industry	D	++ facilitates product innovation	short to medium-term	dynamic	high
			++ ↑ efficiency			
			+ ↑ global competitiveness			
	Investors	D	+ lower costs	medium-term	static	medium
			- joint liability risk	long-term		low
	Authorities	D	- efforts to agree & implement changes	one-off	static	certain
			- ↑ workload linked to coop. mechanisms	long-term		medium
Amend UCITS Directive to allow master-feeders	Industry	D	+ facilitates product innovation	short to medium-term	dynamic	high
			+ ↑ efficiency			
			+ ↑ global competitiveness			
	Investors	D	+ lower costs	medium-term	static	medium
			- joint liability risk	long-term		low
	Authorities	D	-- efforts to agree	one-off	static	certain
			- ↑ workload linked to coop. mechanisms	long-term		medium
Do nothing	Industry	D	- product innovation hindered	short-term	dynamic	certain
			-- less efficiency			
			- less global competitiveness			
	Investors	D	-- higher costs	short-term	static	certain

Option **Virtual Pooling**	**Affected parties**	**Effect** Direct: D Indirect: I	**Impacts** Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	**Impact Timing** One-off Short-term Medium-term Long-term	**Impact Nature** Dynamic Static	**Impact Likelihood** Certain High Medium Low
Amend UCITS Directive to allow virtual pooling	Industry	D	++ facilitates product innovation	short to medium-term	dynamic	high
			++ ↑ efficiency			
			+ ↑ global competitiveness			
	Investors	D	+ lower costs	medium-term	static	medium
			- joint liability risk	long-term		
	Authorities	D	-- efforts to agree	one-off	static	certain
			- ↑ workload linked to coop. mechanisms	long-term		medium
Mandate CESR to develop guidelines on virtual pooling	Industry	D	+ facilitates product innovation	medium-term	dynamic	medium
			+ ↑ efficiency			
			+ ↑ global competitiveness			
	Investors	D	+ lower costs	medium-term	static	low
			- joint liability risk	medium-term		medium
	Authorities	D	-- efforts to agree	one-off	static	certain
Do nothing	Industry	D	- product innovation hindered	short-term	dynamic	certain
			-- less efficiency			
			- less global competitiveness			
	Investors	D	- less protection	medium-term	static	low
			-- higher costs	short-term		certain

Management Company passport

A management company passport can be defined as the possibility a) for a UCITS to appoint a management company in another Member State or b) for a management company to establish a UCITS in another Member State.

Problem description

Centres of excellence have developed in some parts of the EU. Concentration of certain functions of the value chain in those centres has led to economies of scale and of know-how. Restrictions to the way in which the industry gets organised can break this virtuous circle.

Amendments made to the UCITS Directive in 2001 (also called UCITS III amendments) introduced important changes in respect of management companies[80]. Some of them, such as the new provisions on minimum capital requirements and increased risk control obligations appeared a necessary counterweight to the enlarged investment powers of UCITS. UCITS III amendments opened also the door to a greater freedom for the management company to offer services across borders[81], as laid down in Art. 6.1 of the Directive.

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

81 Recital 7 of the Management Company Directive lists the activities that a management company, duly authorised in its home Member State, should be permitted to carry on in host Member States. These

However, when setting the conditions to avail of this freedom, Art. 6a.4 and 6b.3 refer only to the provision of the portfolio management service mentioned in Art. 5.3, i.e. individual portfolio management, and of investment advisory services and custody (also Art. 5.3 services).

When transposing the Management Company Directive, only two Member State provided for the possibility for UCITS based in its territory to appoint a management company abroad[82]. National regulators' main concern seems to be that the subsequent split of supervision would undermine investor protection[83].

In its transitional provisions guidelines[84], CESR considers that "… the legislator's intention does not seem to have been to impose to UCITS home Member States to recognise the possibility for a foreign management company to set up an investment company in their own constituency". This interpretation would not be inconsistent with Recital 7 of the Management Company Directive since the management tasks listed in it can be exercised via delegation arrangements. CESR, therefore, concludes that, for the time being, CESR members "can only permit an open ended investment company to designate a management company in the same EU jurisdiction". The passport would be, however, possible for the Art. 5.3 services; thus, leaving out the core activity of a management company: collective portfolio management (CPM).

The possibility to passport those Art. 5.3 services have been exploited to a limited extent by European management companies. The following table shows the number of management companies which have applied to passport those services. The actual use of that freedom is, however, uncertain.

The low take-up of this possibility (some 10% of the total number of management companies) was, for the IFME Expert Group, the proof of a mismatch between the services available and what the industry really wanted to do.

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activities would be distribution of funds that the company manages and all the other functions and tasks included in the activity of collective portfolio management.

82 It seems, that only two Member States, UK and Italy, allowed it. However, this possibility does not appear to have been given effect in practice.

83 The UCITS would be supervised by the authority of its home Member State whereas the management company would be under the supervision of the Member State in which it had been authorised. The supervisory authority responsible for the UCITS would have therefore no legal means to call directly to account a management company located in another jurisdiction.

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

Table 16: Use of Management Company Passport

CESR MEMBER	MC having sought the freedom to provide individual portf. management on a cross-border basis	MC having sought **also** the freedom to provide the other art. 5.3 services on a x-border basis	Total number of MC	Number of MC having converted to UCITS III
Austria	2	2	23	23
Belgium	5	0[a]	5	5
Cyprus	0	0	2	0
Czech Republic	0	0	9	9
Denmark	1	1	14	13
Estonia	0	0	7	7
Finland	0	0	27	27
France	103	N/A	495	145
Greece	3	0	26	26
Germany	3	1	47	47
Hungary	2	0	24	2
Iceland	0	0	6	6
Ireland	1	0	70	91
Italy	0	0	179	73
Luxembourg	4	3	186	132
Malta	0	0	0	0
Netherlands	4	4	45	7
Norway	10	4	22	22
Poland	0	0	24	24
Portugal	8	0	16	16
Slovakia	3	2	10	10
Slovenia	0	0	15	15
Spain	0	0	112	112
Sweden	11	0	72	39
UK	7	0	139 [b]	N/A
Total	167	17	1575	851

Source: CESR and individual Member States. Please note that data is not necessarily reported at the same date.

[a] The possibility for a MC to offer the service of safekeeping has not been implemented in the Belgian Law.

[b] Total number of MCs of UK authorised schemes.

Independently of the intention of the legislator, the possibility for a UCITS to appoint a management company abroad is ruled out for contractual funds[85]. Art. 3 requires that both a contractual UCITS and its management company be situated in the same Member State. Also Art. 1a.5 establishes that the home Member State of a contractual UCITS is that where its management company has the registered office. Finally, according to Art. 4.2 the same competent authorities will be responsible for the authorisation of the UCITS and the approval of its management company.

The impossibility, in practice, for a UCITS to appoint a management company abroad has important consequences. Asset management groups have to establish management companies in all countries in which they set up fund ranges. This results in a duplication of resources[86] and impedes the industry from benefiting from greater specialisation and economies of scale related gains. Cost are thus pushed up and inevitably passed on to the investors. UCITS III "substance" requirements (minimum capital, at least two persons conducting the management company's business…) are said to considerably exacerbate the situation. According to EFAMA, the fully-loaded costs of a management company in an EU jurisdiction are approximately € 1 million a year. The Expert Group on IFME considered that "the establishment and maintenance of a UCITS III management company in an 'exporting' country can cost between € 500,000 and € 1 million". Outsourcing "substance" does not appear to be much cheaper[87].

The possibility to delegate management provides a certain degree of flexibility to organise the business and allows exploiting specialisation advantages. However, it is said to add on complexity and costs. Delegation arrangements still require a completely functional management company in the fund's home Member State (i.e. it does not avoid the duplication of resources). Some consider that a real passport would result in a more transparent structure which would be easier to monitor (than delegation agreements). This should therefore reduce operational risks[88].

Table 17: Problem table

Which is the problem? (*reasons)	What are the consequences?
Ineffective management company passport * limited to Art 5.3 for corporate funds (R) * ruled out by Directive for contractual funds (R) * important supervisory concerns (O)	A fully functional management company needs to be established in the fund's country ⇒ duplication of resources → higher costs ⇒ unexploited scale economies → higher costs ⇒ untapped specialisation gains → higher operational risks → higher costs

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85 According to the industry, this discrimination would be unnecessary since the domicile of a contractual UCITS could be determined by its fund rules (e.g. specifying that the domicile would be that of the regulatory authority which issues its UCITS Certificate). See appendices to the report on IFME.

86 This not only implies staff, premises, administration and legal costs but also the cost of capital.

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

88 Stronger risk management or lower operational risks were for example mentioned in the contributions to the Green Paper consultation of EFAMA, FEAM, Goldman Sachs Asset Management, IMA, the Swedish Investment Fund Association and in the UK HM Treasury and FSA joint response.

Objectives

General objectives:

- Enhance the fund market efficiency
- Maintain high levels of investor protection

Specific objectives:

- encourage cost savings
- improve industry's ability to exploit specialisation and locational benefits
- improve the working of cooperation mechanisms between regulators
- ensure that investors' interests are not compromised

Description of options

i. Amend the UCITS Directive in order to improve the working of the management company passport. Changes could focus on fine-tuning existing provisions and eliminating potential inconsistencies.

ii. Encourage CESR to develop guidelines (level 3) to give effect to art. 6c (+ 52a and 52b) cooperation provisions.

iii. A two-step approach consisting on further analysis of the existing situation in the short-term and possible adoption of new legislation in the long-term.

iv. Do nothing

Impact assessment

i. Amend the UCITS Directive

The removal of inconsistencies could be undertaken in two directions. First, making clear that, as concluded in the CESR guidelines, the management company passport covers only Art. 5.3 services. This, however, although providing greater legal certainty would not have a significant impact in practice. The missed opportunities described above will persist. Second, confirming the possibility of a "full" management company passport, i.e. a passport covering both Art. 5.3 and CPM activities. In order to overcome split supervision concerns, this would require reworking the cooperation mechanisms in Art. 6c, 52a and 52b. The implications of this second approach are detailed below:

Industry: Important potential cost savings are believed to exist, in particular for pan-European groups having an important number of management companies in different jurisdictions. According to Feri data, there are 1749 active European management companies belonging to 987 groups. Considering the cost figures provided by EFAMA and the Expert Group on IFME, if each asset management group would be allowed to operate from only one

location, savings could vary between € 381 and € 762 million/year. [89] This savings would have to be added to those resulting from enhanced economies of scale. These, however, are much more difficult to estimate. Some consider that the scope for savings will be reduced by increased costs on the side of the depositary (that will have to monitor a management company from abroad) [90]. Others, that part of the costs will remain since the management company would still have to comply with different national rules[91]. However, economies and specialisation gains will produce their effects also over the long-run. Greater market integration and (possibly) higher global competitiveness should reinforce these dynamic effects.

Investors: Centralisation of the risk control management and specialisation gains should increase the quality of products and may reduce operational risks. A working cooperation mechanism among regulators would clarify which regulator is responsible for different risks/monitoring. On the one hand, this would alleviate potential investors concerns about the redress following a complaint. On the other, protection gaps and redress delays may occur. As regards, to the costs savings achieved, investors are expected to indirectly benefit from them. However, as in the case of the other market efficiency issues, gains would most probably be passed on to them slowly (if at all).

Authorities: Given national authorities' reticence[92] to the management company passport, long discussions are to be anticipated. Another difficulty relates to the scope of the passport, in particular how to define CPM. Is Annex II of the UCITS Directive still relevant or should it be adapted? Do some of the CPM's services need to stay in the country of the fund? Once an agreement has been achieved, reliance on information exchanges and other cooperation mechanisms may increase the time- and work-load of supervisors.

Additionally, amendments put in place under this option could also extend the passporting possibilities to contractual funds, thus eliminating the existing discrimination among fund types. Considering that contractual funds lack legal personality, it would however raise greater concerns from the supervisory point of view. Concerns could be mitigated by imposing greater responsibilities on the depositary[93] (which would remain in the fund's domicile). But this may counterbalance part of the savings achieved at the level of the management company. But this may counterbalance part of the savings achieved at the level of the management company. Other possibility would be to clarify in the contractual arrangement between the fund and its management company the law that applies.

ii. CESR guidelines

Most of the public authorities replying to the Green Paper consultation considered that a necessary pre-condition for the introduction of the passport was enhanced cooperation among

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89 There is, however, a risk that this figure may overestimate the situation. The existence of different management companies within a group may respond not to regulatory constraints but to business or commercial motivations (e.g. when the management company is created to take care of a particular business line).

90 e.g. AFTI's response to the Green Paper consultation.

91 e.g. the Austrian Ministry of Finance's response to the Green Paper consultation.

92 In the framework of the consultation on the Green Paper, 13 (out of a total of 15) national authorities stressed split supervision concerns. Of those, 11 did not consider a management company passport to be a priority.

93 e.g. as recommended in the Citigroup's response to the report on IFME.

supervisors. The details of this cooperation could be worked out in the framework of CESR in the form of guidelines.

While this may alleviate supervisory concerns[94], it would still be necessary to clarify the ambiguities in the Directive and probably to introduce new provisions on which to build the cooperation mechanism. As explained above, it would very much depend on the willingness of CESR to work on this issue and to adapt their national legislation in line with the agreed guidelines.

iii. Two-step approach

Both the responses to the Green Paper consultation and the work of the Expert Group on IFME have shown that there remain still too many open issues as regards the management company passport.

Thus, as a first step Commission services would aim at:

- Re-defining the detailed list of (core and non-core) activities that a management company can carry out.
- Determining which of those activities should stay in the country where the fund is domiciled making the distinction between corporate and contractual funds[95].
- Assessing the industry's appetite for the passport (i.e. which of the activities that could be passported does the industry really want to carry out across borders?)
- Clarifying how Art. 6c, 52a and 52b cooperation mechanism could be improved in order to remove potential split supervision concerns (this could be done on the basis of CESR's level 3 guidelines)

On the basis of this it would then be possible to better assess the economic potential of a full management company passport.

The second step would then define the precise changes to be done to the Directive at a second stage if considered justified. This solution, however, implies postponing straightforward cost savings.

iv. Do nothing

The problems highlighted above will persist if no remedial action is taken. The consequences of the current duplication of costs and (often) complex delegation arrangements (i.e. higher fees and operational risks) would be borne by investors. The relatively high levels of protection provided to investors will however remain.

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94 It remains to be seen whether CESR would be willing to spend time and resources on this matter and, even if this would be the case, whether non-binding guidelines would be implemented.

95 A number of respondents to the report on IFME are in favour of a passport covering the maximum range of activities (e.g. see responses of AFG, IMA and FSA)

Comparison of options

The management company passport has been one of the recurrent topics for discussion in the recent years. However, the degree of priority for regulators is rather low; split supervision related concerns remain. There is neither a consensus on the industry side on the desired scope of an 'ideal' management company passport[96].

Despite this, the advantages of a functional management company passport cannot be disregarded. Organisation at an important level of the fund industry value chain would finally respond to economic and specialisation motivations and therefore be more efficient. Option i., amending the Directive, is in principle worth pursuing. There remain, however, some open issues: scope of the passport, how to extend it to contractual funds, the re-design of the supervisory mechanisms… For that reason, it would be advisable to develop preliminary proposals that would then be tested for viability, coherence and effectiveness with all concerned parties. The preferred option is therefore a combination of option i. with an accelerated version of option iii. (two-step approach)

Table 18: Overview of impacts

Option	Enhance market efficiency	Maintain high levels of investor protection	Observations
Amend Directive to make passport work	+	+	Complex solution
CESR guidelines	?	+	Low effectiveness
Two-step approach	+	+	Delayed solution
Do nothing	-	+	Opportunity costs but high investor protection

96 Please see the report on IFME.

Table 18: Impacts

Option	Affected parties	Effect Direct: D Indirect: I	Impacts Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Impact Timing One-off Short-term Medium-term Long-term	Impact Nature Dynamic Static	Impact Likelihood Certain High Medium Low
Amend Directive to make passport work	Industry	D	+ ↑ organisational flexibility ++ ↑ efficiency + ↑ global competitiveness	medium-term	dynamic	high
	Investors	I	+ lower costs	long-term	static	medium
		D	- ↓ protection	medium-term		low
	Authorities	D	-- efforts to agree & implement changes	one-off	static	certain
CESR guidelines	Industry	D	+ ↑ organisational flexibility + ↑ efficiency + ↑ global competitiveness	medium-term	dynamic	low
	Investors	I	+ lower costs	medium-term	static	low
		D	- ↓ protection	long-term		
	Authorities	D	-- efforts to agree	one-off	static	certain
Two-step approach	Industry	D	+ ↑ organisational flexibility ++ ↑ efficiency + ↑ global competitiveness	long-term	dynamic	medium
	Investors	I	+ lower costs	long-term	static	medium
	Authorities	D	-- efforts to agree + implementation	one-off	static	certain
Do nothing	Industry	D	- less organisational flexibility - less efficiency - less global competitiveness	short-term	dynamic	certain
	Investors	D	- higher costs	short-term	static	certain

Depositary passport

The Directive entrusts depositaries with two types of functions: the safe-keeping of assets (also called custody function) and monitoring the respect of the law and the fund rules/instruments of incorporation (also called oversight function). The depositary constitutes then a key safeguard for UCITS investors and a cornerstone of European fund regulation.

The passport would allow the depositary to offer its services across borders.

Problem description

A depositary passport is currently ruled out by the UCITS Directive. The Directive requires that the depositary be established in the same Member State as the management company for contractual funds or of the UCITS itself if it is of a corporate type[97]. This restriction seemed to be justified by two considerations: a) the duties to be carried out by the depositary needed a close relation with the management company/ investment company and b) since the same competent authority has to authorise the management company/investment company, approve the choice of depositary and supervise their activities, it appeared logical that both have the same location[98].

That requirement restricts the choice of depositaries by UCITS to locally domiciled depositaries rather than the best/most efficient services provider. The resulting fragmentation of the value-chain is said by parts of the industry to lead to untapped economies of scale[99]. However, others consider that economies of scale have already been largely exploited through delegation arrangements[100]. It can also be argued that the passport would accentuate the concentration[101] in the depositary market, and risk pushing up fees.

However, what raises greater concerns is the risk for investor protection that the passport could entail[102]. The UCITS Directive defines a minimum set of principles and obligations leaving Member States free to regulate many aspects of the depositary function. As a result different models have emerged in the different Member States. National regimes differ regarding the legal status of the depositary, the extent of its oversight functions, its ability to delegate certain activities, its required minimum capital or its liability in respect of the safe-keeping of assets[103]. The introduction of the passport could therefore be detrimental to investor protection, particularly considering that the broadening of investment possibilities introduced by UCITS III would open the door for more complex products. Hence the even greater relevance of the depositary's oversight functions[104]. A passport without prior harmonisation would also create a non-level playing field among depositaries.

However, the depositary passport cannot be analysed in isolation since it may have an influence on other market efficiency issues. According to the Commission's Communication on depositaries, the fragmentation in the European depositary market is an additional obstacle to cross-border mergers[105]. Being able to provide custody services from another Member State is also considered necessary to implement cross-border virtual pooling. On the other hand, a

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97 Art. 8 and 15.
98 Art 4.2
99 Report on IFME.
100 e.g. ALFI and Schroders' responses to the Green Paper consultation.
101 The degree of concentration can be measured by the market share of the top 5 custodians in a country. According to For the EU, on average, this market share is closed to 70%. In many new Member States it is closed to 100%. (ZEW/OEE's report: "Current trends in the European asset management. Lot 1", September 2006)
102 Many respondents to the Green Paper consultation mention a reduction of the quality of the depositary's oversight and split supervision as the main risks of the passport.
103 Appendices to the report on IFME
104 Please see Associazione Bancaria Italiana and BNP Paribas' responses to the Green Paper consultation.
105 COM (2004) 207 final, 30 March 2004

depositary passport is often considered to be incompatible with the management company passport[106].

Table 19: Problem table

What is the problem? (*reasons)	What are the consequences?
Depositaries' cross-border provision of services restricted * passport ruled out by Directive (Regulatory) * delegation of custody cross-border not always allowed (Regulatory) * other MS banks' branches not always allowed to act as depositaries (Regulatory) * important supervisory concerns (Others)	The depositary needs to be established in the fund domicile ⇒ duplication of resources → higher costs ⇒ unexploited scale economies → higher costs

Objectives

General objectives:

- Enhance the fund market efficiency
- Maintain high levels of investor protection

Specific objectives:

- encourage cost savings
- improve industry's organisational flexibility
- ensure that the quality of the depositary's oversight function is not reduced

Description of options

i. Amend the Directive to enable depositaries to passport their services. This would also imply including provisions aimed to harmonise the role and responsibilities of depositaries.

ii. Amend the Directive to introduce a passport for custody services. This would imply that oversight functions will continue to be performed by a depositary based in the fund domicile.

iii. Provide greater flexibility for depositaries to organise their business on a pan-European basis. This could be done by encouraging changes in national laws in order to enhance delegation possibilities and/or to allow branches of banks authorised in another Member State to act as depositary. The corresponding measure could take the form of a Commission Recommendation or CESR guidelines (level 3)

iv. Do nothing

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106 See, e.g. responses to the Green Paper consultation by JP Morgan and Verbraucherzentrale Bundesverband. Also, among the responses to the report on IFME, the French Treasury considers that maintaining the depositary in the country of the fund would provide enough protection for the management company passport to be given effect.

Impact assessment

i. Amend the UCITS Directive to allow for a full depositary passport

Industry: Possibility to appoint a depositary in another Member State should foster efficiency and specialisation gains. In addition, the harmonisation of the role and responsibilities of the depositary may facilitate cross-border business since it will reinforce investor confidence. It would also level the playing field between depositaries. Industry competitiveness could be improved.

Investors: Unitholders would be subject to a more homogeneous level of protection. This could be considered as particularly relevant if the cross-border business continues to grow. Investor participation in the resulting savings would depend on the level of competition within the fund industry.

Authorities: Respondents to the Green Paper consultation see the need for prior harmonisation of the role and responsibilities of the depositary as a necessary pre-condition for a depositary passport. Many of them also highlighted the difficulties in achieving such harmonisation[107]. The existence of divergent (but valid) approaches makes it challenging. Regulatory efforts both in terms of time and costs are therefore deemed to be considerable (without any guarantee that they will succeed).

Thus, the feasibility of this option is doubtful. Regarding its impact, funds have often already access to custodians in another Member States (via sub-custodian agreements) and therefore additional savings will be limited. In addition, depositary costs are a limited component of total fund costs and depend on the size of the fund[108]. Thus, fostering economies of scale (e.g. pursuing any of the previous sections option) may be a more proportionate way of realising cost savings in this area.

ii. Amend the UCITS Directive to provide for a passport for the custody function

The passporting of the oversight function raises important concerns given its impact on investor protection. However, the custody function is in practice largely harmonised. Splitting both functions and allowing the custody function to be provided across borders could be less problematic from the regulatory point of view. This would also make sense from an economic point of view since the potential for economies of scale savings within the oversight function are said to be much smaller[109].

Thus, this option would probably lead to gains close to those of option i., while alleviating most of the supervisory and investor protection concerns of a full depositary passport. However, it would still require an important investment on the part of regulators first to agree on the changes to be made to the UCITS Directive (e.g. definition of safe-keeping and related responsibilities/liabilities) and then subsequently to implement them. Considering the input

107 Scepticism is expressed in the responses to the Green Paper consultation of the CSSF, DATA, DFIA, the French Ministry of Economy and Finance, FEAM or the UK Treasury & FSA joint contribution.

108 CRA report.

109 According to the Associazione Bancaria Italiana, cost differences among countries reflect the different oversight obligations placed on local depositaries (response to the Green Paper consultation).

received from market participants, it is not clear that this would add important incremental benefits to those already obtained via existing arrangements[110].

iii. Greater flexibility to organise the depositary function

As described in section c., this could be achieved by enlarging delegation possibilities (e.g. allowing the delegation of safe-keeping across the border) and/or by enabling branches of banks authorised in another Member State to act as depositaries.

This would not require a change to the Directive. Art. 7.2 and 14.2 already provide for the possibility to delegate safe-keeping to third parties. Art. 8.1 allows the depositary to be established in the host Member State if it has its registered office in another Member State. The choice of the legal status of depositary is left to national regulators[111]. This option would not require a systematic change of all Member States' national legislation, since in some of them those freedoms already exist.

Independently of the method chosen to implement this measure (e.g. Commission Recommendation or CESR guidelines), its effectiveness will very much depend on the willingness of the Member States that do not yet allow for the use of those freedoms to do so.

iv. Do nothing

CRA report shows that US custody costs are a fraction of the European average. Thus, continuation of the present situation will maintain unnecessarily high costs (that will be inevitably borne by the investor). However, justification to proceed with changes involving liberalisation of the oversight function seems less straightforward for the reasons explained above.

Comparison of options

Public consultations have not demonstrated that there are significant missed opportunities that require EU level action in this area. Some consider that the European depositary market is functioning effectively and that organisational flexibility and economies of scale are already possible via delegation[112]. In addition, potential cost savings are not considered to be large. Only the custody function offers certain potential; but fees are already low[113]. In this framework, options i. and ii. seem disproportionate given the important efforts that they will require. On the other hand, option iii. would achieve a certain level of benefits with lower costs (please see table below). It is, therefore, the most cost-efficient (and preferred) option. As regards the interaction with other market efficiency issues, this option would facilitate the implementation of virtual pooling without necessarily being incompatible with the management company passport.

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110 E.g. DATA's response to the Green Paper consultation.

111 It has just to be a institution subject to public control and to furnish sufficient financial and professional guarantees (Art 8.2)

112 E.g. Banca d'Italia, DFIA and IMA's responses to the Green Paper consultation.

113 E.g. DFIA and IMA's responses to the Green Paper consultation.

Table 20: Overview of impacts

Option	Enhance market efficiency	Maintain high levels of investor protection	Observations
Amend Directive to enable full passport	?	+	Doubtful feasibility
Amend Directive to enable custody passport	+	+	Non-proportionate solution
Greater flexibility	+	+	Most cost-effective solution
Do nothing	-	+	Opportunity costs

Table 21: Impacts

Option	Affected parties	Effect Direct: D Indirect: I	Impacts Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Impact Timing One-off Short-term Medium-term Long-term	Impact Nature Dynamic Static	Impact Likelihood Certain High Medium Low
Amend Directive to enable full passport	Industry	D	+ ↑ organisational flexibility + ↑ efficiency + ↑ global competitiveness	medium-term	dynamic	medium
	Investors	D	+ lower costs	long-term	static	Medium
			- ↓ protection	medium-term		Low
	Authorities	D	-- efforts to agree & implement changes	one-off	static	Certain
Amend Directive to enable custody passport	Industry	D	+ ↑ organisational flexibility + ↑ efficiency + ↑ global competitiveness	medium-term	dynamic	Medium
	Investors	D	+ lower costs	medium-term	static	medium
			- ↓ protection	long-term		low
	Authorities	D	-- efforts to agree	one-off	static	certain
Greater flexibility	Industry	D	+ ↑ organisational flexibility + ↑ efficiency + ↑ global competitiveness	medium-term	dynamic	medium
	Investors	D	+ lower costs	medium-term	static	medium
	Authorities	D	- implementation efforts	one-off	static	certain
Do nothing	Industry	D	- less organisational flexibility - less efficiency - less global competitiveness	short-term	dynamic	certain
	Investors	D	- higher costs	short-term	static	certain

Fund order processing

Order processing is the process of initiating, placing, executing and settling a fund order. The players typically involved in this process are distributors, transfer agents, (aggregators), fund promoters, depositaries and custodians.

Problem description

The placing and to a certain extent the settlement of orders does not follow a same model all over Europe. A myriad of inconsistent processes exist (even within the same country[114]). Sometimes executed inefficiently. Order processing still relies on manual intervention[115]. Around 50% of all relevant transactions are processed using paper[116]. This entails important operational risks due to the misinterpretation of data, the loss of orders, mis-keying or other human errors. The lack of automated processing can add delays to the treatment of orders and push up processing costs. The fragmentation resulting from different national systems implies that those costs, delays and operational risks step up in the case of the processing of orders of funds domiciled abroad.

Developments in the industry add to the problem. Volume growth of fund transactions is requiring more efficient fund processing[117]. The growing cross-border business and changes at the distribution level (e.g. growth of open architecture) translate into a growing number of actors (transfer agents, assemblers, distribution platforms…) and interlinkages that renders fund order processing more complex[118]. There is therefore a risk that the absence of an effective pan-European fund execution and processing life-cycle will exert a real drag on the efficiency of the whole market. The need for regulator's action is however uncertain. The problem is not of a legal or regulatory nature. What is needed are cost-efficient solutions to organise back-office processes.

There exist pan-European, national and private industry-led initiatives to overcome the problems described[119]. However, the results to date are slow. Important investments are required to automate processes. Besides, not all players have the same incentives to move in that direction. Some intermediaries find in the lack of standardisation and automatisation a business opportunity.

Table 22: Problem table

What is the problem? (*reasons)	What are the consequences?
Fund order processing is not standardised nor automatised * an important part still done manually (Others) * inconsistent organisation of processes often based on bilateral agreements (Others) * growing complexity of the processes and number of concerned actors (Others)	A myriad of different order routing (and settling) systems ⇒ higher operational risks ⇒ higher costs ⇒ processing delays

114 Processes are often organised on the basis of bilateral agreements between the actors concerned.
115 Funds Europe, October 2005.
116 Funds Europe, July 2006.
117 Funds Europe, August 2006.
118 Oxera report.
119 Examples of those are EFAMA's Fund Processing Standardisation Group's recommendations (February 2005), IMA Fund Processing Principles (January 2006) and Clearstream's Central Facility for Funds.

Objectives

General objectives:

- Enhance the fund market efficiency
- Maintain high levels of investor protection

Specific objectives:

- encourage cost savings
- reduce operational errors and processing delays

Description of options

i. Amend the UCITS Directive in order to harmonise fund order processing. This could be done by introducing provisions detailing the working of the processing of fund orders. Alternatively, it could also be done by defining its main characteristics and leaving for level 2 (or 3) the description of the technicalities (Lamfalussy approach).

ii. Non legislative solution (e.g. a Commission Recommendation)

iii. Do nothing

Impact assessment

i. Amend the UCITS Directive

A harmonised framework for pan-European fund order processing would have the following effects:

Industry: Market players will lose leeway to organise their business. Significant implementation costs will have to be borne by those having to change their processing systems without this being always justified by business needs. These costs could be particularly important in the case of small players. Long-term gains in efficiency and the reduction of operational risks may well compensate those one-off investments. However, regulatory induced changes in the processing area may distort economic forces and lead to market failures.

Investors: Lower operational risks should indirectly benefit investors. The extent to which costs savings will flow to them will depend on whether they accrue directly to the fund or to the market players. In the first case, the investor can expect higher net returns. In the second, the competitive forces and the respective bargain power of each market player will determine how gains are distributed.

Authorities: Efforts to reconcile different national systems may prove to be time-consuming. Given the additional burden that it will impose on domestic players, the decision on which standards/processes to adopt will be highly political. It would also require a high knowledge and understanding by regulators of the processing cycle. This will imply an important investment in terms of time and efforts on their side. Similar implications can be expected if changes follow the Lamfalussy approach.

However, given the fact that the identified problems do not result form regulatory or legal barriers, the justification for public action is weaker. It is also questionable that regulation could impose the choice of architecture or technology.

ii. Soft law solution

Promoting standardisation and automation of fund processing via for instance a Recommendation will give greater flexibility to Member States to adapt national systems to particular domestic needs or preferences. CESR could be also invited to develop guidelines on this matter. On the other hand, it is doubtful that this option will be more effective than on-going industry's initiatives given the non-binding character of that legal instrument. Benefits for the industry and investors are therefore uncertain while the efforts and time for regulators would not be negligible[120].

iii. Do nothing

In the case of fund order processing the "do nothing" is strictly confined to action at EU level because the industry has already taken up this issue on its own initiative. A working group organised by EFAMA, for example, is working on proposals on how to make the processing more efficient. It might, however, be argued that in the absence of any EU level measure, there is a certain risk that industry-led initiatives will not result in effective solutions due to the conflicting interests in the industry: usually each player would like to have its own system installed as standard in order to avoid adjustment costs. In that case, higher operational risks and excessive costs would continue to be borne by both industry and investors. However, a legislative would take some years as well and it would be difficult for the legislator to develop an appropriate, fair and up-to-date system on its own. It would rather have to rely of contributions by the industry and thereby facing the same problem of having to reconcile conflicting interests. Not to act first seems therefore to be an appropriate approach for the Commission. Only if no progress is being made by the industry the Commission might provide some support in order to break the deadlock.

Comparison of options

Industry reorganisation of technical processes would be probably more efficient if it responds to economic incentives. Regulatory induced changes risk creating a rigid framework without adding necessarily investor protection benefits. According to the subsidiarity principle, actions should be left to those actors apt to solve more efficiently the market failure. The preferred option is therefore the 'do nothing' one, i.e. letting the industry to proceed with its efforts without public interference. This is consistent with the responses to the Green Paper on investment funds' consultation and the report on IFME which considered that there is no role for public authorities to play in this process at this stage.

[120] CESR could be also invited to develop guidelines on this matter. However, their effectiveness will probably not be higher than that of a Recommendation while still requiring an important investment in time and efforts to agree on the side of national regulators.

Table 23: Overview of Impacts

Option	Enhance market efficiency	Maintain high levels of investor protection	Observations
Amend Directive	+	+	Market distorting
Non-legislative measures	?	?	Effectiveness doubtful
Do nothing	+	+	Higher operational risks, opportunity costs

Table 24: Impacts

Option	Affected parties	Effect Direct: D Indirect: I	Impacts Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Impact Timing One-off Short-term Medium-term Long-term	Impact Nature Dynamic Static	Impact Likelihood Certain High Medium Low
Amend Directive to harmonise fund order processing	Industry	D	+ ↓ operational risks	short to medium-term	dynamic	medium
			+ ↑ efficiency	medium-term		
			+ ↑ global competitiveness	medium-term		
	Investors	I	+ lower costs	medium-term	static	medium
			+ ↓ risks	long-term		
	Authorities	D	-- efforts to agree & implement changes	one-off	static	certain
Recom-mendation on fund order processing	Industry	D	+ ↓ operational risks	medium-term	dynamic	low
			+ ↑ efficiency	medium-term		
			+ ↑ global competitiveness	medium-term		
	Investors	I	+ lower costs	medium-term	static	low
			+ ↓ risks	long-term	static	
	Authorities	D	- efforts to implement	one-off	static	certain
Do nothing	Industry	D	- higher operational risks	short-term	dynamic	certain
			-- less efficiency			
			- less global competitiveness			
	Investors	I	- higher costs	medium-term	static	medium
			- higher risks	long-term		

Investment policy restrictions

Problem description

Clear restrictions on the assets on which a UCITS can invest and the techniques it can use are one of the pillars of investor protection deeply rooted in the Directive. However, prescriptive restrictions often struggle to pass the test of time. Continuous financial innovation renders a rigid framework inevitably out-of-date. Investment techniques and assets outside that framework develop and become common currency. Often financial innovation finds its inspiration in market developments (e.g. bear market periods may encourage the design of hedged or guaranteed products). Sometimes financial innovation tries to accommodate changes in the needs of investors such as retirement financing (e.g. liability-driven

investing[121] is increasingly sought by pension funds managers). If the legislative framework does not keep up with those trends, both managers and investors would lose business and investment opportunities. The scope of the missed opportunities is however difficult to quantify.

2001 amendments to the UCITS Directive enlarged the investment possibilities for UCITS managers[122]. These broadened the range of eligible assets such as money market instruments, funds or derivatives and allowed the use of techniques such as hedging or index replication. Some consider this move not to be enough[123]. It is however still too early to assess the impact of those 2001 changes.

From the investor protection point of view, some believe that excluding part of the investment possibilities offered by other investment products is not justified. These products are said not to be always riskier than UCITS (particularly since these can now use derivatives). Besides, UCITS restrictions make it difficult to compete with products outside the Directive scope. There is therefore a risk that investors move to less regulated but more attractive products (i.e. products that are innovative, more adapted to their needs and often less costly) [124].

Table 25: Problem table

Which is the problem? (*reasons)	What are the consequences?
Investment and business possibilities for investors and industry limited * UCITS Directive rigid framework unable to adapt to financial innovation (Regulatory)	UCITS unable to respond to evolving investors' needs or preferences ⇒ missed opportunities for the UCITS industry ⇒ investors' ↑demand for less regulated products → investor protection risk

Objectives

General objectives:

- Foster single market gains
- Maintain high levels of investor protection

Specific objectives:

- foster business opportunities for industry players

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[121] LDI generally involves a conservative part invested in bonds in order to meet liabilities and a more aggressive part aiming to generate performance. Hedge funds are often used in this more aggressive part of the portfolio (Funds Europe, August 2006).

[122] Amending Directive 2001/108/EC of 21st January 2002 also called the "Product Directive"

[123] A number of respondents (e.g. Assogestioni, Dekabank, EFAMA, Union Investment) to the Green Paper consultation believe that the UCITS framework should also accommodate open-ended real estate funds and/or funds of hedge funds.

[124] This has been stressed repeatedly not only during the Green Paper consultation, but also in the IFME report and at the open hearing on the Expert Groups' reports (Brussels, 19th July 2006). At this event, an industry participant noted even that all regulatory restrictions can be by-passed through product structuring.

- widen the investment and risk diversification opportunities for investors
- avoid the detrimental effects on investor protection that competition with investment products outside the UCITS framework may have

Options description

i. Amend the UCITS Directive in order to enlarge its investment powers. This would imply allowing UCITS to make use of investment techniques such as leverage and/or short-selling; as well as, to invest in HFs and/or property. There exist varied possibilities depending on the scope of the additional investment powers. Four will be analysed.

i.1. Amend the UCITS Directive in order to allow the broader range of investment techniques and assets possible. This would be equivalent to create a common framework for all Collective Investment Schemes (CIS).

i.2. Amend the UCITS Directive in order to accommodate funds investing in real estate.

i.3. Amend the UCITS Directive in order allow Hedge Funds strategies.

i.4. Amend the UCITS Directive in order to accommodate funds investing in Hedge Funds (i.e. Funds of Hedge Funds).

i.5. Amend the UCITS Directive in order to accommodate funds investing in Private equity

ii. Amend the UCITS Directive in order to introduce broader Lamfalussy capability. Level 2 work could then go beyond the clarification of definitions powers provided for in Art. 53a.

iii. Two-step approach consisting on a) an evaluation of the actual use of the investment powers introduced by the 2001 amendments and b) legislative changes if required.

iv. Do nothing

Impact assessment

i. Amend the UCITS Directive in order to enlarge its investment powers.

Amendments would not only concentrate on surgical changes to a small set of Directive investment requirements (e.g. articles on UCITS investment policies). Changes would need to be made to other parts of the Directive (e.g. regarding the duties of the management company/depositary). Stricter risk control requirements would be necessary to maintain high standards of investor protection. Particular attention should also be paid to the information provided to the investor. Products would grow in complexity. However, there is no evidence

that retail investors are becoming more sophisticated in their understanding of financial products[125].

i.1. Amend the UCITS Directive in order to cover CIS in general.

Despite falling outside of the UCITS framework, some of the non-harmonised CIS may share certain UCITS characteristics. For example, real estate funds in a number of Member States can take the form of an open-ended fund and daily redemption is possible at least in one case. Funds of hedge funds (FoHFs) are available investments for the retail investor in some countries.

However, broadening the UCITS framework, while keeping its basic principles, would not be feasible. The general implications of this first option are described below. More concrete consequences of allowing specific techniques or investment in certain category of assets are detailed further down.

Industry: Greater business opportunities will be open to industry players. This may boost assets under management and therefore lead to scale savings. Bringing non-harmonised CIS into the UCITS framework would benefit from existing management capabilities and know-how and thus foster specialisation and scale economies. The industry could also take advantage of existing infrastructure (e.g. experienced middle and back offices) and distribution channels to exploit new business opportunities more quickly. A pan-European regime including until now non-harmonised CIS would also help to develop these business in those Member States in which there are still non-existing. On the other hand, it will imply probably cumbersome efforts to re-adapt to a new regime, particularly for the industry players of those countries where a national regime has recently been implemented. (This, however, as one-off effect should be compensated by the long-term gains expected from the development of the business.) Another disadvantage will be the risk of weakening the "UCITS brand". It has been sometimes argued that the broadening of investment powers introduced by UCITS III could render more difficult the acceptation of UCITS in third countries. Widening the UCITS brand to cover CIS that are often considered as riskier may then have a detrimental effect on UCITS attractiveness/acceptance beyond the EU borders. The impact can be noticeable since around 20% of European funds' third-party sales are done outside Europe. There is also the risk that, if there would be any problem linked to the use of derivatives, the whole range of UCITS (including 'plain-vanilla' ones) would suffer the consequences.

Investors: In addition to the new risk diversification possibilities, investors (notably retail investors) could have access to strategies and techniques that had been until then reserved to a few. This will allow them to better adapt their investments to their needs/preferences. Investors will also enjoy a homogeneous level of protection all over the EU. However, the new products available to them would grow in complexity. They will be more difficult to understand and therefore make harder for the (retail) investor to take well informed decisions.

[125] The PwC Survey 2006 already mentioned (see footnote 21) states that retail investors are not only not becoming more sophisticated but that, in most markets, they tend to buy the latest hot performers and then stick with them just as they have always done.

Authorities: Agreeing a common approach considering the different already existing regimes for non-UCITS CIS could be challenging. On the other hand, the fact that not all Member States have introduced the corresponding national legislation yet could help the process.

However, this move will raise two questions. First, that of compliance with the structural principles of the UCITS Directive. Some will need to be relaxed or removed. Besides, broadening the scope of the Directive to accommodate all the investment possibilities offered by the non-UCITS schemes would not be straightforward. The particularities of some non-harmonised CIS would make difficult "one size fits all" approaches. Second, the question of suitability for sale to retail investors. It is doubtful that all CIS should be accessible to all kind of investors. A possible solution would be then developing different classes of CIS with certain particular characteristics but within the same framework (UCITS being one of them), although this might create confusion. Another possibility would be widening the UCITS framework to accommodate only certain type of CIS as analysed below.

i.2. Amend the UCITS Directive in order to accommodate funds investing in real estate.

Bringing Real Estate Funds (REFs) into the Directive have been supported in recent years by some pan-European industry organisations such as EFAMA. This move could make sense in principle. Open-ended retail REFs legislation has already been tested in some Member States (e.g. in Germany and Austria). National experiences could therefore serve as a basis to design an appropriate framework. Besides, REFs do not present the degree of complexity of other non-UCITS CIS and would probably be easier to understand. Actually, most investors tend to have already a direct exposure to the real estate market.

However, important UCITS principles would have to be abandoned. Some of the Directive restrictions will have to be adapted. Concretely the Directive rules out the investment in property (unless if the acquisition "is essential for the direct pursuit of its business"). The maximum borrowing powers of Art. 36.2 may not be high enough to allow the financing through mortgages (often used for tax reasons) of property. Most importantly, the principle that units should be redeemed on request set by Art 37 seems difficult to respect given the lack of liquidity of a REF underlying investments[126]. The difficulty to valuate those investments amplifies the problem[127]. Other potential risks associated with the valuation of the assets, such as lack of transparency and conflicts of interest, may require special investor protection provisions. Additional, disclosure and valuation requirements would need to be included in the amended Directive[128].

In addition to the effects detailed in the analysis of option i.1, the development of the REFs business could give an important boost to the European real estate sector. This could have a

[126] In some countries such as France, the redemption of units is only possible if there exists a buyer for them. When daily redemption is the rule, e.g. in Germany, the law requires the fund to hold sufficient liquid assets in order to face any potential exit.

[127] The traded price for a property fund value does not necessarily represent the actual market value of the underlying assets. Discounts to the funds Net Asset Value per unit may be above 15% (source Ernst&Young website).

[128] E.g. valuation by independent appraisers.

direct impact on economic growth. Its scope may however be limited by adverse tax implications (particularly in the absence of bilateral tax treaties) [129].

i.3. Amend the UCITS Directive in order allow Hedge Funds strategies.

UCITS III by extending the investment powers of UCITS have somehow blurred the limits between traditional and alternative investment funds. In particular, the use of derivatives allows UCITS to replicate some classical Hedge Funds (HFs) strategies. Nevertheless, many of the constraints imposed by the Directive, such as quantitative limits, eligible assets restrictions or the prohibition to sell short, render impossible many HFs strategies. The principle that UCITS are open-ended funds redeemable on request would also pose problems. Given the often illiquid nature of their underlying investments, lock-up periods (or low frequency redemption possibilities) are often necessary to successfully implement some HFs strategies. Relaxation of all those UCITS constraints and principles may be questionable from a (retail) investor protection point of view. It is also doubtful that such an approach would be effective. Even if the amended Directive would limit the offer of UCITS using HFs strategies to qualified or sophisticated investors, the product approach of the Directive does not seem to be the most appropriate one. The rapid market developments in that area would render the amended Directive out-of-date rather quickly. Business risks also moving to less restrictive jurisdictions off-shore.

i.4. Amend the UCITS Directive in order to accommodate funds investing in Hedge Funds (i.e. Funds of Hedge Funds).

Funds of Hedge Funds (FoHFs) are said to be more diversified and therefore less risky than single HFs. For some, this means that they could be offered for selling to retail investors, which is already the case in certain Member States[130]. However, given the low degree of transparency that normally characterises HFs, a FoHF could lead to a greater risk concentration (rather than diversification), e.g. when the strategies of the underlying HFs are (highly) correlated. UCITS diversification requirements would most probably be of little use and would need to be adapted. Also to compensate for the negative impact on the performance of the double layer of charges, some FoHFs are said to use leverage when investing in underlying HFs. This may then exacerbate market risk. Strict 'due diligence' and disclosure provisions would then need to be defined in the amended Directive (and possibly also rules on the use of leverage). The role of the prime broker should also be regulated.

While this seems feasible, there remains however the problem of liquidity. Being invested in HFs with very often a limited redemption policy, FoHFs may find difficult to respond to investors redemption requests. Also other eligible assets criteria[131] such as "accurate, reliable and regular prices" or "regular, accurate and comprehensive information available" may be difficult for underlying HFs to comply with. As in the case of previous analysed options, the "eligible assets" criteria will have to be adapted.

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129 Real estate funds may be subject in the countries where their assets are located to a) withholding taxes on dividends and interest levied at source b) taxation of capital gains realised and c) taxes on income (e.g. the rent).

130 "There is also a broad consensus that offering funds of hedge funds to retail investors might be more 'acceptable' than allowing direct investment in single strategy hedge funds" EFAMA's response to the Green Paper consultation.

131 Please see "CESR's Advice to the European Commission on Clarification of Definitions concerning Eligible Assets for Investments of UCITS", January 2006.

i.5. Amend the UCITS Directive in order to accommodate funds investing in Private equity

Although many of the UCITS requirements and restrictions could be extended to Private Equity Funds (PEFs) some would not make much sense. The objective of the investment (management strengthening and growth financing) and its illiquidity make of PEFs long-term investments. Art. 37 requirement to redeem units on request would then not be easy to comply with. Also the difficulty to valuate underlying investments would disqualify them as "eligible assets" unless the current criteria are adapted (cf above for funds of hedge funds) [132]. Valuation problems may also give rise to transparency and conflict of interest related concerns[133]. This may require additional disclosure requirements and possibly a common understanding on accepted valuation techniques.

Further to the general effects detailed for option i.1, the development of the PEFs business could give a boost to the European economy. The Private Equity industry plays an important role in the financing of private enterprises. It can therefore make a valuable contribution to innovation, job creation and economy growth by encouraging the creation of new enterprises and revitalising existing ones. However, difficulties for the Member States to agree on a common framework could be amplified for the close interlink with other relevant issues such as company law, accounting or taxation. In particular, differences in fiscal regimes discourage cross-border capital raising and investing by private equity funds. In the absence of a common understanding of what constitutes a fiscally transparent PEF structure, a pan-European private equity industry will be seriously hindered. It seems therefore too early to try to define a pan-European regulatory framework for PEFs. Other alternative solutions could be more appropriate (please see section 1.2.3.)

ii. Amend the UCITS Directive in order to introduce broader Lamfalussy capability.

An important piece of work on the clarification of eligible assets has just been completed. CESR's advice based on extensive discussions and, notably, two open consultations, has been generally welcomed by the industry. It will soon be translated into Level 2 measures (expected to be adopted early in 2007). These measures would need time to prove their effectiveness. It may therefore be advisable to assess it before opening again the debate.

There is also another argument of a more practical nature in favour of not embarking at this stage in hasty changes. Broadening the investment possibilities of UCITS would require more emphasis on risk management processes. However, the enlarged powers to use derivatives introduced in 2001 are said not to be matched by risk management expertise[134]. This may call for an in-depth study on the use of the 2001 new investment powers (please see below).

In any case, it could make sense to establish a mechanism to allow eligible assets evolve in line with market developments as recommended by the European Parliament[135]. This could be done by widening the powers given to CESR by Art. 53a. This would open the door to a revision of the eligible assets and techniques whenever justified by changes in the market.

[132] Please see the previous footnote.

[133] Typically part of the manager remuneration will depend on the (accumulated) performance of the portfolio of investments.

[134] Please see footnote 21.

[135] Please see the European Parliament's report on asset management (2006/2037(INI)), March 2006 (also called the Klinz' report).

Such a revision could take place periodically or being initiated by Commission services. The corresponding Level 2 implementing measures could then be developed and adopted within shorter delays than those required to change the Directive itself. However, the scope of the revision at level 2 would be within the limits of the principles agreed upon at level 1.

iii. Two-step approach: mid-term review.

This option could imply launching a study or survey to assess to which extent the new investment powers introduced by the 2001 amendments are actually being used. The study/survey should also identify difficulties/shortcomings encountered in the implementation of the new powers. This could be complemented with an analysis of the investment possibilities open to non-harmonised CIS, particularly those that are accessible to retail investors under the corresponding national framework. The results would be the basis for a re-assessment of the situation. This review would inform possible future legislative changes. However, the use of the new investment possibilities depends to a certain extent on the clarification of eligible assets on-going work. It may therefore be advisable to wait for the Level 2 measures to enter into force before concluding any evaluation. This is therefore a medium-term solution.

This approach, although providing the input and time necessary to a meaningful update of the Directive in the medium-term, would not eliminate the need to readapt the Directive to new developments in a longer term.

iv. Do nothing

The burst of the technologic bubble and the bear market that followed are still fresh in the memories of many investors. This is driving them to look for absolute returns, in-built guarantees and capital protection. Investors' needs are also evolving. Demand for a reliable investment vehicle offering a cost-effective solution to the pension crisis will increase gradually. Maintaining the status quo would deprive UCITS investors from greater risk diversification possibilities and from innovative and flexible products capable of responding to their needs. On the side of the UCITS industry, a rigid framework would also prevent market players from exploiting new business opportunities. From a regulator point of view, the risk that investors demand would be re-oriented to less regulated investment products is a source of concern.

Comparison of options

The risk diversification and investment/business opportunities that a broadening of the investment possibilities of UCITS would bring about are no doubt important for both investors and industry players. The scale of the missed opportunities is however unknown. From a feasibility point of view, the UCITS model cannot be stretched indefinitely. Particularly if its retail character is to be preserved. It risks losing its credibility as high investor protection product. This may reduce the attractiveness of the UCITS brand inside and outside EU borders. Some think that such a move would create regulatory complexity and confusion. Besides, widening the investment possibilities cannot be done without renouncing to important UCITS principles and features. This will change the very essence of UCITS.

From a regulator point of view, the risk that investors will move to more attractive (but less regulated) products outside the UCITS framework could be addressed with other measures (e.g. the market efficiency measures analysed earlier) that may prove more cost-efficient.

However, financial innovation will continually test the limits of the UCITS Directive. Some in-built review mechanism may need to be considered if one wants UCITS to pass the test of time. However, this does not appear as a straightforward solution in the short-term. In the meantime, the preferred option is a continuous monitoring by Commission services. This will entail carrying out all relevant research in order to better prepare any potential changes to the scope of the Directive in the medium-term (option iii). On the other hand, addressing the question of the distribution of non-harmonised CIS to (qualified) investors could be another route to explore to achieve the objectives set out in this section, at least for certain categories of investor. This route is explored further below in section 1.2.3.

Table 26: Overview of Impacts

Option	Foster single market gains	Maintain high levels of investor protection	Observations
Amend Directive to cover all CIS	?	?	Feasibility doubtful
Amend Directive to allow investments in real estate	+	?	UCITS concept put into question
Amend Directive to allow HFs strategies	-	-	Business risks to move off-shore
Amend Directive to cover FoHFs	+	?	UCITS concept put into question
Wider Lamfalussy possibilities	?	+	Limited impact
Two-step approach	+	+	Medium-term solution
Do nothing	-	-	Opportunity costs + investor protection risk

Table 27: Impacts

Option	Affected parties	Effect Direct: D Indirect: I	Impacts Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Impact Timing One-off Short-term Medium-term Long-term	Impact Nature Dynamic Static	Impact Likelihood Certain High Medium Low
Amend Directive to cover all CIS	Industry	D	+ ↑ business opportunities	short to medium-term	dynamic	low
			+ ↑ efficiency	long-term		medium
	Investors	D	+ ↑ investment and diversification opport.	medium-term	static	medium
			- ↑ risks	long-term		
	Authorities	D	-- efforts to agree & implement changes	one-off	static	certain
Amend Directive to allow investments in real estate	Industry	D	+ ↑ business opportunities	short to medium-term	dynamic	medium
			+ ↑ efficiency	long-term		
	Investors	D	+ ↑ investment and diversification opport.	medium-term	static	medium
			- ↑ risks	long-term	static	
	Authorities	D	- efforts to agree & implement changes	one-off	static	certain
Amend Directive to allow HFs strategies	Industry	D	+ ↑ business opportunities	short to medium-term	dynamic	low
			+ ↑ efficiency	long-term		
	Investors	D	+ ↑ investment and diversification opport.	medium-term	static	medium
			-- ↑ risks	long-term		high
	Authorities	D	-- efforts to agree & implement changes	one-off	static	certain
Broaden Directive to cover FoHFs	Industry	D	+ ↑ business opportunities	short to medium-term	dynamic	medium
			+ ↑ efficiency	long-term		
	Investors	D	+ ↑ investment and diversification opport.	medium-term	static	medium
			- ↑ risks	long-term		
	Authorities	D	- efforts to agree & implement changes	one-off	static	certain
Greater Lamfalussy possibilities	Industry	D	+ ↑ business opportunities	long-term	dynamic	low
			+ ↑ efficiency			
	Investors	I	+ ↑ investment and diversification opport.	long-term	static	low
			- ↑ risks			
	Authorities	D	- efforts to agree & implement changes	one-off	static	certain
Two-step approach	Industry	D	+ ↑ business opportunities	long-term	dynamic	medium
			+ ↑ efficiency			
			- efforts to provide evaluation input	one-off	static	certain
	Investors	I	+ ↑ investment and diversification opport.	long-term	static	medium
	Authorities	D	- efforts to collect the information	one-off	static	certain
			- efforts to agree & implement changes			
Do nothing	Industry	D	- less business opportunities	short-term	static	certain
	Investors	D	- risk of move to less regulated products	long-term	static	medium

Distribution level

Simplified prospectus

It is necessary that investors have access to the products which best suit their needs. Effective and standardised risk and cost disclosures are essential for the direct marketing of investment funds to retail investors. To this aim, the UCITS Directive requires that a simplified prospectus be offered to investors free of charge before the conclusion of the contract. The requirements for the simplified prospectus have been specified by Commission Recommendation 2004/384/EC[136] on some of the contents of the simplified prospectus. Initially, the introduction of the concept of the simplified prospectus was regarded as a big step forward. It brought up many issues of relevance for investors, e.g. fees and charges (TER).

Problem description

However, the simplified prospectus, as currently implemented, does not meet the objective set out in the Directive, namely to provide a useful tool for investors to enable them to take an informed investment decision. In most cases, the document is too long and not understood by its intended readers. In certain cases (e.g. umbrella funds), it became even longer than the full prospectus. Member States implemented the simplified prospectus in different ways and some established additional stringent national requirements in spite of the Recommendation. The outcome is that the investors are faced with different sets of information, which are difficult to compare and which not enable investors to make informed purchasing decisions. In short, an extensive paper-tiger - of limited value to the end-investors and a considerable overhead for the fund industry.

The main objective of the simplified prospectus is to help the retail end-investor to make an informed investment choice. The failure of the simplified prospectus results from trying to do too many things at the same time: provide regulatory information (get a higher degree of comfort in the cross-border notification process), marketing tool, and financial education. This failure has probably to be attributed to the deficient specification in the Directive.

The legally non-binding nature of the Recommendation and the fact that it leaves optional choices to Member States in certain cases resulted in divergent interpretations of the UCITS Directive in the different Member States and thus many different simplified prospectuses[137]. At the same time, the Recommendation was criticised as being too detailed and touching upon too many topics. As a result, consumers do not read the simplified prospectus as they find it not understandable. It contains too much information, uses legal jargon and is not investor friendly because of its complex format.

Analyses and consultations revealed that market players and regulators do not regard the simplified prospectus itself as a failure but the way it has developed. . Standardised disclosure has a future. However, to improve upon the status quo, the simplified prospectus needs to be revised, both in form and content, to meet the following basic principles:

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

137 There are indications that sometimes even within one Member State, different types of simplified prospectus were used depending upon who produced them (e.g. in France).

- Its main purpose should be to help the retail end-investor to make an informed investment choice.

- It should be a document which is understood as the key pre-contractual information to be used in the context of the pre-contractual phase between fund promoters/ distributors and the (potential) client.

- The liability of the various parties involved should be clear.

- It should not necessarily be driven by the goal of providing immediate comparability between funds.

An indicative list of the potential issues to be addressed to meet such principles can be found in the Annex to this section.

Objectives

The main objectives of the current simplified prospectus regime presented below remain valid.

Specific objectives:

- enhance effective investor information

- advance the comparability of UCITS for investors within the Community

- ensure effective investor protection and enhance investor confidence in the fund industry

- create a single market for investment funds: facilitate cross-border marketing of UCITS

General objectives:

- to enhance the fund market efficiency and

- to maintain a high level of investor protection

Operational objectives:

- ensure compliance of national rules and procedures with internal market principles

- restore the relevance of the simplified prospectus for retail investors

- boost competition and transparency in distribution by means of an effective tool for comparisons

- reduce risks and improve information and choice for investors without hindering financial innovations

- more cost-effective disclosure procedures

In the light of the problems outlined above it is important to see the objective to make the simplified prospectus work in the current, constantly evolving context of greater product diversity, changing distribution patterns, competition from outside the investment fund "box" and the use of new (distribution) technologies such as the internet.

Description of options

In order to achieve the above objectives, six options have been identified. Some differ mainly in the choice of instrument and not necessarily much in terms of substance. However, different instruments can imply considerable differences in terms of timing, effectiveness, enforceability and likelihood of compliance. This already allows a relatively thorough assessment of the chances of the options to achieve the above-mentioned objectives. At this stage of the preparation of the White Paper it would be too early to decide on the very details and technicalities of the potential revised simplified prospectus. An indicative list of potential changes can be found in the Annex to this section.

i. Do nothing

The do nothing option would mean that no further action would be taken at EU or national level in a coordinated way. The shortcomings listed in the problem section would continue to impede the achievement of the objectives outlined in the Directive and the Recommendation.

ii. Modify the Recommendation

The legal design of the Directive allows for the use of a recommendation to clarify certain elements of the Directive in order to ensure a common reading thereof. This has already been tried with the Recommendation. Given the experience gained since then, one option would be to modify the Recommendation to address some of the issues raised in the problem section.

The advantages would be that it is a very flexible instrument and that it could build on the experience with the current one. It would allow the Commission to outline a way forward towards a (more) harmonised simplified prospectus that could take into account concerns by stakeholders as expressed in the consultation process in the run-up to the White Paper. It would then be up to national regulators to see if they prefer deterring industry and investors from the benefits of such a harmonised simplified prospectus for national reasons or opt for the implementation of the revised simplified prospectus.

However, the fact that the Recommendation does not have binding legal force was considered to be one of the main shortcomings of the current simplified prospectus regime. No enforcement action can be taken on the basis of non-compliance with a recommendation issued by the Commission.

iii. Abolish the Simplified Prospectus

This option would mean putting more emphasis on the role of the intermediary in the sales process. The "duty of care" of such intermediary would determine the level of information to be given to each individual investor. The MiFID conduct of business rules would play an important role in this process. In addition, the intermediary would also have to determine the right moment in the sales process to deliver such information. As a result, responsibility to properly inform investors would most likely be shifted further from asset managers to distributors.

For self-directed investors, this would mean that no standardised pre-contractual disclosure document would be available to help them to make comparisons and investment decisions. However, they could access the full prospectus and any other documents made available by the fund promoter to support the direct sales process. It would not necessarily mean that the full prospectus becomes the up-front disclosure document.

iv. Amend UCITS Directive: specify core principles and implement a Lamfalussy-type approach

This option includes two elements. Firstly, an amendment of the existing UCITS Directive would implement (some of) the changes described in the annex and other relevant elements of the current recommendation directly into the Directive. Secondly, the opportunity of the amendment of the Directive would be used to adapt the relevant provisions of the Directive to the Lamfalussy system of framework principles; thereby introducing a mechanism for easier adaptations in the future. Implementing powers would be delegated to a second level[138].

v. Level 2 measure: clarification of definitions pursuant to Article 53a of the Directive

Article 53a of the Directive empowers the Commission to introduce technical amendments to the Directive in accordance with the procedure referred to in Article 53b(2) of the Directive in the following areas only:

a. clarification of the definitions in order to ensure uniform application of the Directive throughout the Community;

b. alignment of terminology and the framing of definitions in accordance with subsequent acts on UCITS and related matters.

Any Level 2 measures which would have to fit within the abovementioned limits of a clarification of definitions. This means that under the current legal framework, no new rights or obligations could be introduced by means of Level 2 measures. Some of the changes proposed in the annex like the proposed changes on the choice and structure of certain ratios, could not be achieved by way of a Level 2 measure. Admissible changes, however, would be legally binding.

vi. CESR Level 3 work: Guidelines on own initiative

In order to facilitate coherent implementation and uniform application of EU legislation by the Member States, CESR may adopt non-binding guidelines (Lamfalussy level 3). These are administrative measures only and have no legally binding force. They can, however, contribute to a more consistent understanding of the provisions on simplified prospectus through co-operation and coordination between (national) regulators/supervisors and thus facilitate cross-border distribution of UCITS. CESR can also adopt common standards regarding matters not covered by EU legislation. Such standards would have to be compatible with Level 1 and Level 2 legislation.

[138] Strictly speaking there would be another option of introducing the changes without "Lamfalussation". However, as the impacts of both parts could be separated for individual assessments, presenting this as two options would result in major repetitions. Given the general preference of stakeholders for a "Lamfalussation" of the respective provisions only this combined option is presented.

Impact assessment

Making the right choice among these instrumental options needs to be carefully balanced, taking into account the following factors:

– pro's and con's of each option;

– level of harmonisation desired;

– urgency of changes;

– cost/benefit analysis of introducing (some of) the proposed changes

i. Do nothing

Under the current circumstances no significant improvements of the situation could be expected. Especially national regulators do not seem to be inclined to change their respective implementation of the Directive and the Recommendation on own initiative as they have not done so during the last years irrespective of industry pressure.

ii. Modify the Recommendation

A modification of the Recommendation could be achieved within a reasonable period of time and certainly faster than an amendment of the Directive. However, the poor record of the current Recommendation would call Member State compliance with such a non-legislative action into question. Changes in national law would still depend on the goodwill of each Member State. Therefore it is be quite difficult to assess the likelihood that certain impacts materialise and in which Member States.

In a best case scenario, Member States would fully comply with the new recommendation and swiftly implement the respective changes into national law. In this case the objectives could be achieved most efficiently and most effectively. In addition, the use of a recommendation would be a very flexible tool for later adjustments if need be.

In a kind of worst case scenario Member States would not react to the issuing of a new recommendation. Then, the option would more or less coincide with the "do nothing" option.

Most likely outcome would lie somewhere between these two extremes with Member States implementing the new recommendation to varying degrees like in the case of the current one. This would most probably result in minor improvements against the status quo. Yet, these improvements would most certainly fall short of achieving the objectives to a satisfactory extent. An insufficient degree of harmonisation would deprive consumers of the availability of a simplified prospectus that is easy to use and allows for comparisons between different funds. Cross-border marketing of UCITS products would not be facilitated much.

iii. Abolishing the Simplified Prospectus

Abolishing the simplified prospectus would prima facie result in cost savings for asset managers: cost of production, documentation, translation and compliance would be eliminated. Furthermore, it would give promoters and distributors greater flexibility in their choice of supporting documentation for the sales process.

However, the industry has already made some investments to comply with the current rules. While these investments would be largely lost, the abolition of the simplified prospectus would create a situation of extreme (legal) uncertainty for all market participants and regulators. In reaction to this, providers would need to develop substitute marketing material within an even less harmonised framework. Member States might at the same time not be willing to sit back and see how the situation develops under MiFID but would most likely try to fill the resulting regulatory gap at national level. This would cause considerable adjustment costs until a new regime has emerged and stabilised.

iv. Amend UCITS Directive: specify core principles and implement a Lamfalussy-type approach

Amending a directive is always a very time-consuming process with all its imponderabilities. But it would allow the introduction of the most far-reaching changes in the system, both in terms of substance and procedure. Its binding nature would ensure a proper and (largely) harmonised implementation within a given period of time.

In this particular case, it would allow pursuing all objectives outlined above. Furthermore, "Lamfalussation" of the Directive's provisions would ensure more flexibility for future changes via Level 2 measures, including the setting of details on the content of the Simplified Prospectus.

v. Level 2: clarification of definitions

The implementing powers conferred upon the Commission under Article 53a of the Directive only allow the Commission to make technical amendments in respect of clarification of definitions. They do not seem to offer sufficient leverage to create the necessary level of harmonization.

Some of the main items contained in the list of potential changes envisaged (e.g. harmonization of TER calculation method), as listed in annex to this section, cannot be achieved in a satisfactory manner using this option.The result would be a piece-meal approach producing only short-term gains which would promise only limited benefits. It would not contribute to a long-term solution. To the contrary, there would be a risk that additional measures would be needed in a few years time.

vi. CESR level 3: Guidelines on own initiative

If CESR would produce guidelines on the implementation of the simplified prospectus this could result in a more consistent and equivalent implementation of the relevant provisions which should facilitate cross-border marketing of UCITS units. Such guidelines could be produced relatively fast, certainly faster than any legislative amendment. Furthermore, the review panel from CESR could play a valuable role in the process.

While such guidelines would, like the current Recommendation, not be legally binding, there would be a certain expectation and peer pressure among Member States that measures they have developed themselves would also be properly enforced. As the preparatory process would be subject to extensive public consultation and be based on an exchange of experience among regulators it could result in a kind of European "best practices". Yet, there would also be a certain risk that it would result in a "consensus" on the smallest common denominator.

CESR guidelines cannot impose a modification of the law, which could be necessary if new obligations are to be proposed (e.g. calculation of TER). Therefore, there are two major flaws in this option. Firstly, chances are rather mixed that CESR members could on their own initiative develop and implement a framework that would achieve the above objectives to a satisfactory degree (taking into account the fact that they could not agree on a harmonised implementation of the current Recommendation in the last years). Secondly, such guidelines would not be legally binding. Leaving the Commission without any opportunity to interfere or enforce the rules.

Comparison of options

The assessment of the options has been done taking into account the ability to attain the objectives defined above. The result is summarised in the following table and explained below.

Table 28 Overview of Impacts

Option		Enhance market efficiency	Maintain high levels of investor protection	Observations
i	Do nothing	≈	≈	
ii	Change the recommendation: new format and contents of SP	(+)	+	Easiest and quickest, but implementation uncertain
iii	Abolish the SP	≈	(-)	Effect uncertain, great risk regarding investor protection/transparency
iv	Amend UCITS Directive: Format of SP and Lamfalussy	+	+	"safest" but most time-consuming solution
v	Level 2: clarification only	≈	(+)	Marginal impacts due to marginal leeway
vi	CESR level 3: Guidelines	(+)	+	Uncertain outcome in terms of contents and timing

Option i is not viable given the importance of the problem

Option ii would, in principle, allow for some short-term remedy but the likelihood that a substantive improvement could be achieved seems rather low.

Option iii is highly uncertain in its effects and might require major follow-up measures concerning the full prospectus. It would therefore result in a high level of uncertainty in the industry.

Option iv is probably the most time-consuming one. But it would promise the achievement of the highest number of envisaged objectives and to the highest degree.

Option v would allow for only minor adjustments which would not have the potential to substantially improve the situation, to solve the identified problems.

Option vi would also be an uncertain "bet".

In essence, all proposed changes to improve the functioning of standardised disclosure for UCITS could be achieved through an amendment of the existing UCITS Directive. It should be pointed out that the process of amending the UCITS Directive would take considerably more time and efforts than the process of drawing up a new Recommendation, modifying the existing Recommendation, or relying on Level 3 coordination and guidelines. However, the

use of a recommendation has proved to be rather unsuccessful in the past, mainly due to its non-binding legal force.

It seems, on the other hand, that Member States, when given too much freedom in respect of implementation of the Directive, tend not to follow more specific guidelines of the Recommendation. For the same reason, the use of CESR guidelines might prove to be insufficient to achieve the desired result.

The use of Level 2 measures at this stage seems not relevant given the limited scope of action it given by Article 53a to the Commission. Level 2 measures could, however, be useful at a later stage if the UCITS Directive itself is restructured reflecting a full Lamfalussy approach.

Summing up, the assessment shows that option iv is the most effective solution. A possible interim solution, namely a combination of option ii and vi, could be considered: The new Recommendation would be turned into legally binding level 3 work once option iv has been implemented, i.e. amendments to the Directive in order to allow for Lamfalussy level 3 work.

Annex

Indicative list of potential changes to format and substance of the Simplified Prospectus

- Title: possible change of title ("simplified prospectus" considered to be confusing)
- Target public: retail investors (possible exemption for institutional investors if fund offered only to such category of investors)
- Structure/format: short document (maximum length) in the form of "fact sheet", standardised headings
- Content (main elements):
  - Investment policy and management style
  - Possible Deletion of the concept of typical investor profile
  - Minimum holding period: to be decided whether it remains
  - Risk profile: to be further decided
  - Performance presentation: standardisation, comparable information, use of bar charts
  - Cost disclosure: TER or similar composite measure (calculation method to be harmonized); to be complemented by entry/exit fees; information that the TER does not encompass all charges; possible deletion of PTR; possible inclusion of cash examples
  - Local information: to be a detachable part of the simplified prospectus
- Translation requirements: simplified prospectus to be available in national language(s)
- Role of home/host state regulator: host state regulator cannot require any additional elements to be added to the simplified prospectus once filed with the home state regulator (other than local information supplement). Self-certification by fund promoter could be considered. The underlying idea is that the fund promoter should provide the competent authorities of the home Member State with the simplified prospectus together with a statement confirming compliance with the Directive prepared by such fund operator.
- Delivery methods / use of internet: adoption of "access equals delivery" approach to be further considered
- Liability Issues/respective roles of promoter and distributor: fund promoter to be responsible for all product related disclosures; distributor to be responsible for other disclosures

Table 29: Impacts

Option	Affected parties Directly: D Indirectly: I	Impacts Positive: +. Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Timing One-off, Short-, Mid-, Long-term **Nature:** Dynamic - Static	Likelihood Certain High Medium Low	Remarks
Do nothing	Industry: D	- lack of an instrument to present advantages in a transparent manner		High	
		- preparing current SP waste of effort		High	
		- costs of producing other information		High	
	Investors: D	- no easy-to-understand and compare information		High	
		- no clear disclosure of costs		High	
		-- increased risk of suboptimal investments		Medium	
	Authorities	- uncertainty about rules in other MS	Long-term	Certain	
Change the recommendation: new format and contents of SP	Industry: D	- costs of adjusting SP, training	short-term	Certain	
		≈/+ level playing field	mid-term	High	
	Investors: D	+ transparency	long-term; static	High	
		+ better informed choice		Medium	
		+ potentially lower costs		Medium	
	Authorities: D	- efforts to adjust to changes	short-term; static	Certain	
Abolish the SP	Industry: D	+ save work producing SP	medium-term; static	High	
		- higher costs producing full P		Medium	
		- probably need for additional info		Low	
	Investors: D	- risk that overwhelmed by full P, relying on advice	long-term; static	Medium	
		- problems in comparing products	Long-term	Medium	
	Authorities: D	+ less work re SP - more (difficult) work in supervision	long-term; static	High	
Amend UCITS Directive: Format of SP and Lamfalussy	Industry: D	- costs of adjusting SP, training	short-term	Certain	
		≈/+ level playing field	mid-/long-term; static	High	
	Investors: D	+ transparency, + better informed choice + potentially lower costs	Mid-/long-term; static	High, Medium, medium	
	Authorities: D	- efforts to adjust to changes	Short-term	Certain	
		+ greater flexibility	long-term		
CESR level 2: clarification only	Industry: D	≈ costs of adjusting SP	short-term	High	Current framework allows only for clarification of existing rules, no substantive changes
		≈/+ level playing field	mid-/long-term; static	High	
	Investors: D	≈ transparency, ≈ better informed choice ≈ potentially lower costs	Medium-/long-term; static	High, Medium, medium	
	Authorities: D	≈ efforts to adjust to changes	Short-term	Certain	
CESR level 3: Guidelines	Industry: D	≈ costs of adjusting SP	short-term	Certain	Outcome and timing difficult to foresee
		≈/+ level playing field	Mid-/long-term; static	High	
	Investors: D	+ transparency, + better informed choice + potentially lower costs	Mid-/long-term; static	High, Medium, medium	
	Authorities: D	- efforts to adjust to changes	Short-term	Certain	
		+ greater flexibility	long-term		

Competition and duty of care

Besides very specific issues like the simplified prospectus or eligible assets there are more general issues that are not dealt with in the UCITS Directive but are of great relevance for the industry and investors and therefore require permanent attention. As outlined above, competition is relatively weak and intransparent in some parts of the investment funds value chain and although there are no specific provisions in the Directive it remains vital to constantly analyse developments in this respect. The same is true for another crucial element of the "UCITS world", namely investor protection in the distribution process. The major concerns recently voiced in this respect regard potential frictions between the UCITS Directive and the Markets in Financial Instruments Directive 2004/39/EC (MiFID) that might result in legal uncertainty and higher costs or even adverse impacts on investor protection.

Problem description

The investment fund industry is in a state of flux: new products emerge almost at a daily rate, products become more complex, distribution systems open up towards open or guided architecture and some investors are becoming more discerning.

In such a context, it is necessary to look beyond standardised off-the-shelf disclosures. There is a certain likelihood that standardised disclosure documents alone will not be enough anymore in the near future. Great attention has therefore to be paid to the way in which funds and other investment products are sold to individuals. It has to be ensured that any conflicts of interest and inducements are properly managed or disclosed and that intermediaries discharge the necessary duties of care to the retail client. The MiFID Directive provides the tools to manage these concerns.

However, the prevailing distribution system in many Member States is characterised by high distribution costs which represent an increasing share of total costs. This gives rise to complaints about insufficient effective competition to drive prices down. Asset managers complain that distributors do not pass cost reductions on to investors.

In view of increasingly complex networks it is likely that this trend might continue. As distribution is dominated by "captive" networks there is very limited competition. It remains to be seen if the current trend towards guided architecture might help to increase competition at distribution level. Currently, there are claims that distributors often seem to be guided by the degree of retrocession not by maximum client benefits. Retrocession agreements, however, are in general not disclosed to clients.

The fact that provisions on advertising and consumer protection are not harmonised at EU level does not help either. The inconsistent implementation of UCITS III itself is not supportive to cross-border competition. Differences between Member States lead to increased costs/complexity and do not allow investor to understand products and to compare them.

Objectives

The specific objectives here are to provide an effective regulatory framework that is inductive to more competition to ensure that the operation of distribution channels does not undermine the interests of investors and that adequate investor protection is ensured. Transparency of total costs should also be achieved in order to allow investors to fully assess the prospective net gains of different investment products.

Operational objectives would in a first stage be to further analyse these issues and to raise awareness among market participants. Investors should at least be aware of the fact that they are not necessarily provided with all details regarding the costs of investments and that the advice of distributors may be biased. Furthermore, competition in distribution should be monitored carefully and eventually be promoted.

Description of options

i. Do nothing

The current situation would most likely not change as no other actors seem to develop ambitions to become active in this area.

ii. Monitor implementation and effectiveness of MiFID

MiFID is still in its implementation phase. Therefore, it seems not possible yet to draw sound conclusions regarding the impact of this directive on UCITS distribution. This is the more true as the exact interplay between UCITS and MiFID is difficult to predict. This option suggests a proper monitoring of the implementation and effectiveness of MiFID and its impact on the distribution of UCITS. Only on the basis of this analysis further action should be decided if regarded as necessary.

iii. Publish vade-mecums or guidance/recommendations on specific problems

Awareness-raising among retail investors through the publication of information regarding potential cost elements of investment funds and distribution, on the one hand, and guidance and recommendations for authorities regarding competition issues on the other hand.

iv. Clarification of the interplay between UCITS and MiFID as well as the role of competition law with regard to investment funds

Instead of addressing retail investors, this option focuses on the understanding of regulators and distributors of the interaction of UCITS, MiFID and European competition law.

Impact assessment

i. Do nothing

If the situation does not change, investors might choose investment products on the basis of incomplete or even incorrect information. This could lead directly to sub-optimal returns and indirectly to growing frustration among retail investors about investment funds, harming both the industry through reduced volumes and investors themselves as they might opt for second-best investment products. In view of the growing importance of third pillar funds for long-term and retirement savings this could have severe negative consequences for investors' standard of living in retirement. It could also harm the global competitiveness of European asset managers as they would loose out in two ways, firstly because of lower volumes and secondly because of lower profits because of the market power of distributors.

ii. Monitor implementation and effectiveness of MiFID

While the current problems would persist for some more time, to learn more about the effects and effectiveness of MiFID could help developing more effective measures later on. The

envisaged monitoring would also allow assessing whether measures targeted at UCITS only would be most appropriate or rather measures that concern the whole field of application of MiFID.

iii. Publish vade-mecums or guidance/recommendations on specific problems

Specific guidance could help to immediately raise investors' awareness and thereby put pressure on distributors to reveal full costs to retail investors. This would result in better informed decisions by investors. Increased transparency could also trigger to more competition in distribution and force distributors to pass cost savings at the production level on to consumers.

Guidance for and recommendations to authorities could help to improve and harmonise supervision. This should reinforce the effects triggered by guidance to investors.

iv. Clarification of interplay UCITS-MiFID; role of competition law

Clarification could help to avoid divergent trends in the implementation of MiFID and the enforcement of both MiFID and competition law. Direct impacts on the market would be difficult to predict and would most probably not be significant in the beginning. In the longer term, however, such early intervention could result in considerable savings from legal clarity for all market players.

Comparison of options

The assessment of the options has been done taking into account the ability to attain the objectives defined above. The result is summarised in the following table below. The impact analysis did not produce any evidence that urgent action is needed. However, given the importance of the issue, close monitoring of the implementation of MiFID (option 2) seems to be indispensable. Further clarification would only be needed if the monitoring should reveal major problems or if the implementation.

Table 30 Overview of impacts

	Option	Enhance market efficiency	Maintain high levels of investor protection	Observations
1	Do nothing	≈	≈	Current problems persist
2	Monitor implementation and effectiveness of MiFID	≈	≈	No direct impacts, but Commission to learn about sub-optimal developments ASAP
3	Publish vade-mecums or guidance/recommendations on specific problems	≈	≈	Clarifications regarding the interpretation of the directive would increase legal certainty and provide a more reliable basis for industry's business plans
4	Clarification of interplay UCITS-MiFID; role of competition law	≈	≈	Similar to option iii; indication/demonstration to market players that abuse of rights would be prosecuted

Table 31: Impacts

Option	Affected parties Directly: D Indirectly: I	Impacts Positive: +. Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Timing One-off, Short-, Mid-, Long-term **Nature:** Dynamic - Static	Likelihood Certain High Medium Low	Remarks
Do nothing	Industry: D	- asset managers: reduced volumes and profits		Medium	
		+ distributors: increased profit margins		Medium	
				Medium	
	Investors: D	- higher costs		Medium	
		- lower investments because of distrust		Medium	
		- increased risk of suboptimal investments		Medium	
	Authorities	- insufficient supervision/information		Medium	
Monitor implementation and effectiveness of MiFID	Industry: D	Like do nothing	short-term	Certain	
		≈/+ better business opportunities for asset managers ≈/- reduced margins for distributors	mid/long-term	Medium	
	Investors: D	+ transparency	mid/long-term	Medium	
		+ better informed choice		Medium	
		+ potentially lower costs		Medium	
	Authorities D	+ better information about effectiveness of supervision	Mid/long-term; static	Medium	
Publish vade-mecums or guidance/recommendations on specific problems	Industry: D	+ legal certainty, transparency improve market functioning	medium-term; static	Low	
		- gains for producers, losses for distributors		Low	
		+ transparency of costs and inducements, more competition		Low	
	Investors: D	+ better informed choices should improve expected pay-offs	long-term; static	Low	
			Long-term	Low	
	Authorities D	+ better understanding should make supervision more effective	long-term; static	Medium	
Clarification of interplay UCITS-MiFID; role of competition law	Similar to option iii				

Distribution of non-UCITS

Problem description

UCITS is only one part, although important[139], of the collective investment management landscape. Other collective investment schemes (CIS) have been developing in parallel and some, as hedge funds, in a spectacular way. This trend is set to continue. According to a PwC report in 2006, the surveyed Chief Executives considered an expansion in the next three years

[139] According to EFAMA, EVCA and Hedge Fund Intelligence Research data, at the end of the 2005, assets under management amounted to € 5.17 tr for UCITS, € 173 bn for private equity funds, € 269 bn for hedge funds and € 1.4 tr for other non-UCITS.

of hedge funds, private equity and real estate asset classes in detriment of more classical ones such as equity, fixed income and money market[140].

The advantages of those investment vehicles are not negligible. Non-UCITS CIS offer greater risk diversification possibilities, including reduced correlation with securities markets and, at least potentially, higher returns. Thus, they are increasingly attracting the interest of investors. (The burst of the technologic bubble and the bear market that followed are still fresh in the memories of many of them.) However, this growing interest is not only limited to high-wealth or sophisticated investors as has long been the case. Also retail investors are gradually turning to those investment schemes: although most often indirectly, e.g. through pension funds, retail investors' exposure is increasing. This may pose a problem from the investor protection point of view since non-UCITS CIS may be less transparent and riskier. They also tend to be subject to less stringent disclosure obligations.

National regulatory regimes have been introduced over the last years in order to provide a clear, and often supportive, framework for the development of these schemes at the domestic level. Unfortunately, divergent approaches and priorities have given rise to a patchwork of incoherent legislations. For the industry, this translates into an important hurdle to the expansion across borders of their business. For the investors, into poorer investment and risk diversification opportunities. However, missed opportunities are very difficult to quantify.

Table 32: Problem table

Which is the problem? (*reasons)	What are the consequences?
Investment and business possibilities for investors and industry limited * No harmonised framework for a growing range of non-UCITS funds (R)	Non-harmonised CIS are not able to benefit from passport mechanism ⇒ missed opportunities for the fund industry ⇒ investors' ↑demand for less regulated products → investor protection risk

Objectives pursued

General objectives:

- Foster single market gains
- Maintain high levels of investor protection

Specific objectives:

- foster business opportunities for promoters of CIS outside the UCITS framework
- widen the investment and risk diversification opportunities for qualified investors
- avoid the detrimental effects on investor protection that competition between UCITS and CIS outside the UCITS framework may have

[140] Please see footnote 21.

Description of options

i. Amend the Directive to cover a broader range of CIS. This will allow those to benefit from the UCITS passport and access a wider base of investors all over the EU.

ii. Create an EU private placement regime. This would determine the conditions under which certain products could be distributed to certain investors.

iii. Do nothing

Impact assessment

i. Amend the Directive to cover a broader range of CIS.

Different variants to this option has been analysed in detail in the 'Investment policy restriction' fiche. Therefore, the main conclusions apply.

ii. Create an EU private placement regime.

An EU private placement regime would amount to exempt a fund from all or most of the requirements of public offering rules on the basis of its distribution to qualified investors, without discriminating between locally domiciled funds and funds domiciled in other Member States.

The main implications of such a regime would be the following:

Industry: Greater business opportunities will be open to industry players. This may boost assets under management and therefore lead to scale savings. Existing distribution infrastructure may help industry players to exploit new business opportunities more quickly. Opening of other Member States markets will also increase the competition among non-UCITS CIS, putting up pressures to improve efficiency.

Investors: Greater risk diversification possibilities would be open to qualified investors all across the EU. This will allow them to better adapt their investments to their needs/preferences. Qualified investors will also enjoy from a homogeneous level of protection all over the EU, while retail investors will continue benefiting from the UCITS high levels of protection. The increased competition among non-UCITS CIS will also benefit qualified investors. This competition should translate into lowered costs and/or higher performances.

Authorities: Agreeing a common approach would undoubtedly require an important investment from the side of authorities. However, most effort will be of a one-off nature and should largely be compensated overtime by the gains fostered by the opening of EU-wide business opportunities for the CIS concerned.

iii. Do nothing

Similar implications as those explained with regards to the 'do nothing' option in section 1.1.8. are to be expected.

Comparison of options

'Doing nothing' is not a recommendable option. Fund markets are developing rapidly and Commission services would need to closely monitor their evolution. The analysis in section 1.1.8 has also demonstrated that an amendment to the Directive is not the optimum solution. A common private placement regime will allow non-harmonised fund managers and their placement agents to deal directly with qualified investors across the EU and thus to expand their business. The preferred option is therefore option ii.

Table 33: Overview of Impacts

Option	Foster single market gains	Maintain high levels of investor protection	Observations
Amend Directive to cover other CIS	?	?	Feasibility doubtful
Create a private placement regime	+	+	Long-term solution
Do nothing	-	-	Opportunity costs + investor protection risk

Table 34: Impacts

Option	Affected parties	Effect Direct: D Indirect: I	Impacts Positive: + Strongly positive: ++ Negative: - Strongly negative: -- Neutral/marginal: ≈	Impact Timing One-off Short-term Medium-term Long-term	Impact Nature Dynamic Static	Impact Likelihood Certain High Medium Low
Amend Directive to cover other CIS	Industry	D	+ ↑ business opportunities	short to medium-term	dynamic	low
			+ ↑ efficiency	long-term		medium
	Investors	D	+ ↑ investment and diversification opport.	medium-term	static	medium
			- ↑ risks	long-term		
	Authorities	D	-- efforts to agree & implement changes	one-off	static	certain
Private placement regime	Industry	D	+ ↑ business opportunities	long-term	dynamic	high
			+ ↑ efficiency	long-term		
	Investors	D	+ ↑ investment and diversification opport.	medium-term	static	medium
			- ↑ risks	long-term		low
	Authorities	D	-- efforts to agree & implement changes	one-off	static	certain
Do nothing	Industry	D	- less business opportunities	short-term	static	certain
	Investors	D	- risk of move to less regulated products	long-term	static	medium