# RDS

Rivista di DIRITTO SOCIETARIO

Interno, Internazionale
Comunitario e Comparato


*Estratto*

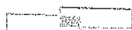

Rivista trimestrale - 2/2009

G. Giappichelli Editore – Torino

# The Commission's UCITS IV Proposal: Is It Sufficient to Create a True Single Market Platform?*

*Marco Lamandini*

***Executive summary.*** – The UCITS IV proposal recasting the 1985 UCITS Directive (85/611/EC) does represent a significant and necessary regulatory improvement of the existing harmonized UCITS regime to foster the construction of a truly pan-European competitive market for European UCITS. The proposal tackles at least some of the regulatory obstacles to a deeper market integration and it should prove effective especially in its new provisions on (national and cross border) mergers and asset pooling. I also welcome the proposals of reform concerning, on one hand, the simplification of the notification procedure to be followed in order to market UCITS units in one or more host Member States and, on the other hand, the shift in the disclosure philosophy, as regards the information to be given to retail investors, from prospectus to "key investor information" (KII). In the legislative debate attention must be paid, however, to the adequacy of the safeguards provided for by the proposal in the interest of unit holders and potential investors at large. Nonetheless, despite the remarkable efforts of the UCITS IV proposal, it seems quite dubious that these major amendments to the UCITS Directive shall suffice to create a truly single market platform. On one hand, the current (provisional) decision of the Commission not to implement a well functioning management companies' passport due to concerns on their proper cross-border supervision, clearly restrains competition on a pan-European scale and limits the efficiency and flexibility gains expected by the industry from UCITS IV. It remains to be seen, therefore, the position which CESR shall take on the Commission request for assistance. On the other hand, it seems that the persisting lack of harmonization of advertisement and marketing rules, albeit partially cured by KII innovation, still makes it difficult for a fund to follow a one single pan-European marketing strategy. The same can be said of the "multitude of ways national tax laws discriminate against foreign funds" (as it has been said in the literature), so as to raise additional barriers to the sale of foreign UCITS funds in their territory. But in my view a major (and perhaps still the major) obstacle to the establishment of a truly pan-European competitive market for UCITS funds remains outside the scope of the Directive and is represented by existing distribution channels.



* Opinion rendered to the Economic and Monetary Affairs Committee on the Commission's UCITS IV Proposal.

Based on market forces alone, an open architecture for their distribution is still lagging behind. Retail investors' preferences are moreover biased, in many circumstances, by the fact that banks and other distributors often advise their customers towards fund products of the own group rather than towards the best performing funds. Rules should correct such market failure and restore a truly competitive European market where product selection is based merely on the criterion of fund performance in the best interest of retail investors.

1. The Committee has requested an opinion on the following question: "UCITS is a European invention and has been very successful since its inception. It now threatens to fall back if European regulation is not flexible enough in order to create a true single market platform. Is the current UCITS IV proposal sufficient in your opinion?". This briefing paper endeavours to answer this (complex) question in the few pages requested and is organized as follows. Paragraph 2 provides a brief survey of the development of European investment fund regulation from UCITS I to UCITS III and shows its impact on the market. Paragraph 3 describes the recognized weaknesses of the existing UCITS regulation and the main features of the UCITS IV proposal of reform also in the light of its impact assessment. Paragraph 4 evaluates the UCITS IV proposal, it comments on its rationale and considers in detail a few new provisions which, in my opinion, should deserve close scrutiny from the EP. Paragraph 5 briefly tries to look ahead, and in particular to assess UCITS IV against the backdrop of the policy goal to establish a truly effective pan-European competitive market for UCITS.

2. The UCITS Directive was designed, from the outset, to promote the free movement of (harmonized) collective investment schemes and in particular to make it easier for a collective investment scheme established in one Member State to market its units in another Member State (recital 2, directive 85/611/EEC). To attain this goal the directive primarily focused on the UCITS as a product and on the cross border marketability of their units, rather than on the market access and regulation of those who manage the UCITS: a feature which, however, was subsequently covered in some detail by the UCITS III amendment (directive 2001/107/EC). As it has been correctly said in the literature [1], "the UCITS I Directive, for the most part, concerns an investment product (and), to a limited extent, regulates investment services providers in the more traditional sense. It stands, as a result, on the cusp between the official listing/public offer regime, which focuses on the capital raising process and trade in securities and the investment service regime which would follow. Its harmonization technique places it with the later investment services regime, however. Its market-integration mechanism of mutual recognition, home country control and the conferment of a regulatory passport is sharply different from the detailed harmonization mechanism used by the official listing regime in the initial phase of harmonization. Indeed, the UCITS Directive serv(ed) as a template in the securities regulation field for the regulatory passport which would come to dominate the regulation of investment services". The legislative history of the directive confirms that the primary goal of this piece of European legislation was the promotion of a single market for these financial products: in fact, albeit the Segrè Report had already advocated community action in 1966 to stimulate, through collective investment schemes, the emergence of a European equity capital market capable to attract the saving of the public at large, by 1976 (at the time of the first Commission proposal) and by 1985 (at the time at the adoption of the UCITS I Directive) collective in-

[1] N. Moloney, *European Securities Regulation* (Oxford, 2002), 244.

vestment schemes were still subject to quite different regulatory regimes in many Member States and, for this reason, were excluded from the two early free movement of capital directives. Collective investment was therefore fragmented along national boundaries. The UCITS I defined, therefore, a set of requirements which open-ended investment funds needed to comply with in order to be eligible for cross border marketing of their units throughout the Community. In particular, the 1985 UCITS Directive lays down common requirements for the organisation, management and oversight of UCITS funds; it defines a list of eligible assets the fund can invest in; it imposes rules relating to the diversification and liquidity of the fund's portfolio. The investment funds complying with the harmonized requirements set by the Directive are subject to the supervision of the Member State where they are established (i.e. "in which the investment company or the management company of the unit trust has its registered office" according to Article 3 UCITS) and they benefit of the mutual recognition by host Member States. However, the passport originally applied only to the investment scheme itself and did not extend to the management company and to the depositary, which had to obtain a separate authorization in each Member State where they wished to operate. The host Member States retain moreover the power to set additional marketing rules concerning the sale of the units in their territory and the supervision thereof.

A recognized success of the 1985 UCITS Directive has been the alignment of Member States on a common and demanding platform of harmonized rules on open-ended investment funds inspired by both market integration and investor protection. As a result, UCITS have enjoyed, so far, worldwide reputation as a well supervised financial product and it is to believe that also for this reason the industry experienced a very remarkable development in most of the Member States in the last two decades and UCITS marketing is now largely successful also in Asia, in the Middle East and in Latin America. According to data released by the Commission, UCITS assets under management amount to € 6 Trillion as of June 2007. Despite the introduction of the passport, however, integration of the UCITS market into a pan-European market has been slow, partly due to diverging practices in the national fund industries (depending also on different investors' risk preferences in several Member States) and partly due to regulatory bottlenecks (due also to national gold-plating in the implementation of the Directive). To respond to the dissatisfaction of the industry, a few years ago the Commission brought about two major amendments to the original regime through the UCITS Product Directive (2001/108/EC) and through the UCITS Management Directive (2001/107/EC) both adopted on 21 January 2002 (UCITS III). The former substantially broadened the eligible assets in which UCITS can invest, allowing investments also in derivatives and funds of funds (thereby prompting a higher degree of retailisation of more sophisticated investment vehicles)[2]. The latter provided, on one hand, the passport to the fund manager (allowed, under a single licence regime, to render its services also in host Member States) and, on the other hand, it introduced a simplified prospectus aimed at giving "key information about the UCITS in a clear, concise and easily understandable way". Despite these efforts, however, the UCITS Directive still fell short of delivering a truly pan-European market for UCITS. Data suggest indeed that "national markets so far remain highly dominated by domestic fund companies" and that "the growth of the EU fund industry should not obscure the fact that the market is far from being a unified market"[3]. As a matter of fact:

a) "foreign fund (present in host Member States) are by far dominated by funds domiciled in

[2] On eligible assets see now Directive 2007/16/EC of 19 March 2007. For a status report on its effects compare PRICEWATERHOUSECOOPERS, *UCITS III/IV News*, March 2008, 1.

[3] F. HEINEMANN, "The Benefits of Creating an Integrated EU Market for Investment Funds", *ZEW*, Discussion Paper no. 02-27, 2.

Luxembourg, Dublin and other tax preference locations. These funds often are of the 'round trip' type: although being cross border in a formal sense, they are designed for a particular national market and the choice of the domicile results from tax reasons";

b) "in small European countries, investors suffer form lack of choice among products: while investors in big markets can choose among thousands of funds, availability is restricted to a few hundred in countries like Denmark, Greece, Portugal and Norway";

c) "There are only 3 countries – Luxembourg, Ireland and the UK – whose funds are sold at least in 2/3 of all member countries. Many national fund industries do practically not export their domestic funds. In no EU country there are today funds available from more than 6 other EU domiciles": a finding that, although partly influenced by the "Luxembourg effect" – beneficial tax domicile used for round trip funds – nevertheless "shows the closeness of national markets" [4].

In addition to that, data on foreign funds' market share confirm that "true foreign funds still play nothing but a minor role" [5].

3. The Commission, following the research and consultation process launched with the Green Paper on Investment Funds (COM 2005 314 final, 12 July 2005) and developed with the White Paper on Investment Funds (COM 2006 686 final, 15 November 2006) and its first Impact Assessment, identified a series of problems and regulatory bottlenecks to industry efficiency. It concluded that EU action in recasting the UCITS Directive would be justified on five issues: a) notification procedures to the host Member State supervisory authority; b) fund mergers; c) asset pooling; d) management company passport and e) a simplified prospectus.

Indeed, the Commission identified as problems requiring a change in the UCITS Directive the following:

a) First, the existing barriers to marketing funds in other Member States represented by the notification procedure introduced by the 1985 UCITS Directive. This proved in practice "often long and cumbersome". According to the Commission, "host regulator's requirements often exceeds those in the Directive and the two month limit is not always respected. As a result the procedure has been compared to a second authorisation of the fund"

b) Second, the proliferation of funds of a sub-optimal size. According to the Commission "the European fund market landscape is characterised by a high number of small funds. At the end of 2006, 54% of European funds managed less than € 50 million in assets. The average European fund is more than five times smaller than its American counterpart [6]. Managing large ranges of small funds is costly. It impedes the exploitation of economies of scale and increases costs".

c) Third, the lack of flexibility in organising the industry value chain. The Commission finds that despite UCITS III "it is currently not possible for management companies to manage a UCITS in another Member State. Ambiguities in the Directive text and split supervision concerns have deprived the relevant 2001 provisions of their effect. As a result fund groups are obliged to establish a fully fledged management company in each Member State where they wish to base a fund range".

d) Fourth, an ineffective simplified prospectus. The Commission finds that "despite the clarification provided by the Commission Recommendation in 2004 (2004/384/EC of 27 April 2004) the simplified prospectus has failed in its mission to provide investors with a useful tool on which to

[4] F. HEINEMANN (*supra*, n. 3), 3-4.

[5] F. HEINEMANN (*supra*, n. 3), 5.

[6] It should be noted, though, that fund size differs considerably among EU Member States: in Italy and the Netherlands, for instance, average fund size is much bigger than in many other Member States: see F. HEINEMANN, (*supra*, n. 3), 5.

base their investment decisions. The simplified prospectus is too long and complex and thus of limited value to the investors. At the same time, the production of the simplified prospectus is relatively costly and time consuming for the industry".

Based upon these findings, the UCITS IV proposal puts forward a reform (and recast) of the existing UCITS Directive whose essential features can be summarized as follows.

a) It envisages a radical simplification of the notification procedure to be followed before starting the marketing of units in a host Member State. Under the new Article 88, if a UCITS proposes to market its units in a Member State other than that in which it is established (such being the State where the investment company or management company has its registered office and head office: Article 4), it shall first submit a notification letter to the competent authority of its home Member State, including: i) information on arrangements made for marketing of units in that host Member State; ii) its fund rules, its prospectus and, where appropriate, its latest annual report and any subsequent half-yearly report translated; iii) its "key investor information" (KII) translated. The home supervisory authority shall verify the completeness of the documentation submitted by the UCITS and then transmit within one month such complete documentation to the competent authorities of the host Member State, enclosing an attestation that the UCITS fulfils the conditions imposed by the Directive. The UCITS may start marketing its units in the host Member State starting from the date of the notification, without having to wait for any formal approval of the host supervisory authority anymore. Under Article 89 the UCITS shall provide to investors in the host Member State all information and documents which it is required to provide to investors in its home Member State: however, such information "shall be provided in the way prescribed by the laws, regulations and/or administrative provisions of the host Member State" and the "KII shall be translated into the official language of the host Member State".

b) It introduces new harmonized rules on UCITS mergers, to be applied both to domestic and cross border mergers (Articles 34-44). Following the results of the impact assessment, these rules attempt at drawing a balance between investor protection and cost efficiency and are centred on disclosure. In order to minimize costs, however, the proposal restricts, under certain condition, the information to be given to unit holders of the receiving fund (a choice which will be discussed below).

c) It introduces new harmonized rules on asset pooling centred (only) on master-feeder structures (Articles 53-62): asset pooling structures whereby at least 85% of the assets of the feeder fund are invested in one single master fund. The impact assessment evidenced, on the contrary, that entity pooling in a broader sense, albeit providing additional flexibility to tailor feeder funds' composition, could amount to a relaxation of the existing provisions on eligible assets and in particular on UCITS funds of funds and that such "relaxation of these diversification requirements could have significant unintended consequences for investors";

d) It brings about a new concept of retail investors' disclosure centred on the "key investor information" (KII) document: a short stand alone document providing in a clear and not misleading manner only the information essential to retail investors to take an informed investment decision.

The Commission's proposal, based upon the findings of its impact assessment which showed substantial supervisory concerns about cross border fund management, maintains, on the contrary, the *status quo* as regards the management company passport, whereby "fund managers undertake cross border management through delegation-based solutions". In recognition however of the interest of the industry for a truly effective Management Company Passport, with a letter of 16 July 2008 the Commission duly requested the assistance of CESR on the supervisory issues which would arise in the event that a UCITS fund was managed by a management company situated in another Member State. Following such advice, the Commission anticipates that it would be able to

consider further amendments to its UCITS IV proposal "to introduce a viable Management Company Passport".

4. In my view the UCITS IV proposal does represent a substantial step forward in the right direction. It tackles indeed at least some of the regulatory obstacles to a deeper market integration and it should prove effective especially in its new provisions on mergers and asset pooling. As anticipated, on fund scale and connected cost efficiency there is a major delay of the European industry if compared to the US industry[7]; a strive towards consolidation and asset pooling seems therefore justified and should normally improve the current situation. Attention should be paid however, in the legislative debate, on the safeguards for investors. In particular, the proposal on UCITS mergers relies on disclosure (Article 40), exit (Article 42) and, to a limited extent, voice for unit holders (Article 41). The (self)-protection of unit holders is complemented, moreover, by the authorisation procedure set out by Article 36, whereby "mergers shall be subject to the prior authorisation by the competent authorities of the merging UCITS home Member State" and "the competent authorities shall consider the potential impact of the proposed merger on unit holders of both the merging UCITS". As recognized also by the Commission, there is here a clear need of protection for investors; this stems from the very fact that the merger by itself affects the portfolio composition of the merging UCITS, necessarily encompassing a change in the risk profile of the investment: a change which varies depending on the degree of homogeneity of the pre-merger portfolio composition but can be very substantial where the merging UNITS follow very different investment policies. The remedy for dissatisfied unit holders provided for by the proposal is exit: "the laws of Member States shall provide that unit holders of both the merging UCITS and the receiving UCITS have the right to request the repurchase or redemption of their units, or where possible, to convert them into units in another UCITS with similar investment policies, without charge". It might be questioned, however, if an adequate level of investor protection does not require also that, in similar exceptional circumstances, unit holders be given on an harmonized EC basis extraordinary voice rights; that, in other terms, the Directive mandates that the merger be approved by a set percentage of unit holders. A solution which, in fact, the proposal envisages under Article 41 but leaves only optional to Member States. Similarly, I do not share the view of the Commission that information on the merger be given only to investors of the disappearing fund and not to investors of the receiving fund, unless the supervisory authority decides that also these investors be informed (Article 40). Such a "mediated" remedy introduces, in my view, unnecessary administrative discretion, it contradicts (at least in principle) the full disclosure philosophy embedded in the Directive and arbitrarily differentiates the protection granted to unit holders where the unit holders of the receiving fund can face risks of performance dilution similar to those run by the disappearing fund's unit holders. Consistently in the corporate field, the merger directives (herein included the cross border merger directive) provide that information be given to the shareholders also of the receiving company. On the contrary, on asset pooling I find fully convincing the balance drawn by the proposal and its rationale as clearly described in the impact assessment. Whilst it is clear that entity pooling in a broader sense would add flexibility in tailoring asset pooling according to changing trends and investors' demands, it is true that, as argued by the Commission, "some of the advantages related to the techniques are already available to industry players thanks to the current funds of funds regime" and the adoption of entity pooling in a broader sense would further relax the existing diversification requirements, deeply modifying the

[7] See also CRA INTERNATIONAL, *Potential cost savings in a fully integrated European investment fund market*, Final Report to the European Commission (Brussels, September 2006), *passim*.

essence of the UCITS product. Moreover I share the view of the Commission that "if the objective of the reform is to achieve economies of scale through the pooling of assets, this seems to be more easily attained through master-feeder structures (through entity pooling in a broad sense, feeder's assets would rather be split into a number of masters)".

In my view also the Commission's proposals concerning simplification of the notification procedure and "key investor information" (KII) are to be welcomed. The former correctly substitutes the existing cumbersome, often uneven (due to gold-plating in the implementation of the Directive) and long procedures currently existing in several Member States, with a real level playing field represented by a streamlined procedure based on a regulator to regulator communication, leaving to the host Member States only the *ex post* supervision on marketing arrangements and local marketing rules. The latter (the KII), in turn, brings about a conceptual revolution on the disclosure philosophy as applied to retail investors. The proposal acknowledges indeed that, as already noted in the literature [8], "a UCITS prospectus is likely to be used to a much greater extent by the average investor (...). UCITS disclosure policy should reflect the fact that the UCITS ultimately acts as an intermediary between the investor and the securities market; disclosure should accordingly be directed towards informing the retail investor who relies heavily on this form of intermediation. (...) Too much information may obscure material facts concerning the UCITS, however, and confuse the investor *who may be unable to distil the key information from the prospectus and may, in the face of overwhelming disclosure, ignore important facts.* The view has been growing in recent years that a simplified prospectus containing clear and essential information and crucially facilitating comparisons between different schemes would more appropriately address the needs of the average investor" [9]. The KII, as described by Article 73, does represent, in my opinion, an appropriate response to such needs and, for the sake of consistency, calls for a more general rethinking of the disclosure documents to be used for retail purposes not only for UCITS marketing, but also in any other public solicitation to retail investors. The reform acknowledges indeed the rational apathy of retail investors in processing extensive investment information and recognizes the inadequacy of a disclosure philosophy based upon the unrealistic assumption that retail investors access and understand all information presented in the prospectus. The importance of the conceptual innovation represented by KII makes it crucial the provision of Article 74 according to which "Key investor information shall constitute pre-contractual information. It shall be fair, clear and not misleading. It shall be consistent with the relevant parts of the prospectus". I do not support, however, the inclusion in the same Article of the precision – which seems to me overly vague, unclear and contradictory – that "Member States shall ensure that a person does not incur civil liability solely on the basis of the KII, including any translation thereof, unless it is misleading, inaccurate or inconsistent with the relevant parts of the prospectus". The industry should be aware that most of retail investors shall take the investment decision solely on ground of the information received by the KII and should be clearly called to act consistently.

5. It remains to be considered, however, if these major amendments to the UCITS Directive shall suffice to create a truly single market platform. This seems to me quite doubtful.

On one hand, the current (provisional) decision of the Commission not to implement a well

[8] N. MOLONEY (*supra*, n. 1), 286.

[9] On KII see also *CESR's advice to the European Commission on the content and form of Key Information Document disclosures for UCITS* (Paris, February 2008), *passim*.

functioning management companies passport (due to concerns on their proper cross-border supervision) clearly restrains competition on a pan-European scale. It limits the efficiency and flexibility gains to be expected by the industry from UCITS IV; moreover, it discriminates the regime of UCITS managers in respect to the full passport regime already applied by MiFID to investment companies. It remains to be seen, therefore, the position which CESR shall take on the Commission request for assistance and in particular if CESR will not be able, as it should be, to devise, also in this respect, a well functioning system of supervisory cooperation (as it was possible, albeit in a different context, with the Supplementary Supervision of Financial Conglomerates) capable to remove the risk, envisaged by the Commission, "to gamble with regulatory failure that could have huge effects on ordinary savers".

On the other hand, it seems to me that the persisting lack of harmonization of advertisement and marketing rules, albeit partially mended by KII innovation, still makes it difficult for a fund to follow a single pan-European marketing strategy, with an increase in fixed cost which diminishes the incentive for a fund to access host Member States unless there is a significant business potential. The same can be said of the "multitude of ways national tax laws discriminate against foreign funds" [10], so as to raise additional barriers to the sale of foreign UCITS funds in their territory.

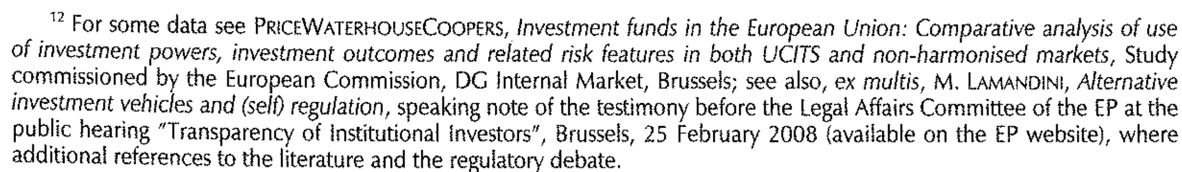
Moreover, in my view, a major (and perhaps still the major) obstacle to the establishment of a truly pan-European competitive market for UCITS funds remains outside the scope of the Directive and is represented by existing distribution channels. This is an issue already identified as requiring some kind of corrective action both in the literature [11] and in the regulatory setting (the Commission acknowledges in its impact assessment that, as things stand now, "at the distribution level the move towards the open architecture – i.e. the fact for a distributor of offering third party funds instead or in addition to its "in house" fund range – is slow, particularly in markets dominated by local banks"). In my opinion, market forces alone proved insufficient to overcome, at least in the short run, such a significant barrier to the establishment of a truly pan-European competitive UCITS market. Thus, community action is needed to push investment firms and banks towards an open architecture for UCITS distribution. To this purpose I believe that, taken into account the ownership structures of the industry, there is a clear need to tackle with specific measures (also through level II and level III measures under MiFID, if appropriate) the conflict of interest underpinning the existing pattern of national preferences. These investors' preferences are indeed biased by the fact that banks and other distributors often advise their customers towards fund products of their own group rather than towards the best performing funds. Rules should correct such a market failure and restore a truly competitive market where product selection is based purely on the criterion of fund performance in the best interest of retail investors.

A last concern regards the lack of regulatory level playing field between the harmonized and widely regulated UCITS product and the non harmonized and scarcely regulated (at least in some Member States and off shore locations) alternative investment vehicles, which are nonetheless increasingly sold also retail throughout Europe. Persisting the approach of self restraint of the Euro-

[10] F. HEINEMANN (*supra*, n. 3), 10.

[11] F. HEINEMANN (*supra*, n. 3), 14: «so far European legislators have non addressed a further topic which might be promising given the above insights on distribution linked obstacles: Pressing fund distributors to behave less biased in selling funds. Of course it is not easy to design measures which could foster more neutral fund selection. The problem is that substantial additional regulatory costs must be avoided since there are not in the interest of the consumers. Nevertheless, given the large relevance of the distribution obstacle for the fragmentation of fund markets legislators should devote more thoughts and efforts to this issue».

pean legislator in setting harmonized, although flexible and MiFID-like rules for alternative investment vehicles (rules still lagging behind at EU level, despite the vivid debate occurred in recent years and months also in Brussels) [12], there might be indeed a risk of regulatory overkill for UCITS. The European path dependent and uneven approach to these increasingly competing financial products could work as a policy-induced disincentive to the further development of a truly pan-European UCITS market.



[12] For some data see PRICEWATERHOUSECOOPERS, *Investment funds in the European Union: Comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets*, Study commissioned by the European Commission, DG Internal Market, Brussels; see also, *ex multis*, M. LAMANDINI, *Alternative investment vehicles and (self) regulation*, speaking note of the testimony before the Legal Affairs Committee of the EP at the public hearing "Transparency of Institutional Investors", Brussels, 25 February 2008 (available on the EP website), where additional references to the literature and the regulatory debate.