

MEMO# 17956

September 21, 2004

ICI PRIORITIES FOR FUTURE UCITS AMENDMENTS

ACTION REQUESTED [17956] September 21, 2004 TO: INTERNATIONAL COMMITTEE No. 46-04 RE: ICI PRIORITIES FOR FUTURE UCITS AMENDMENTS At the International Committee meeting on October 12, 2004, we plan to discuss what the Institute's priorities should be with respect to possible future changes to the UCITS framework. To help prepare for that discussion, this memorandum provides background on the EU UCITS review and sets out possible reform priorities. Background The European Commission will review the UCITS framework under a mandate included in the UCITS Directive amendments adopted in 2002. Specifically, the Commission was asked to review and make recommendations in 2005¹ on capital adequacy requirements for UCITS management companies, regulation of depositories, and the effectiveness of the UCITS regime as a body of regulation and a means to create a single market. We would like to get member input on developing Institute priorities for the upcoming review. A number of ideas now are being discussed in Europe as key matters to address in promoting a truly pan-European market for UCITS funds. For example, the Final Report of the EU Commission's Asset Management Expert Group published in May 2004 mentions the critical nature of some of these issues for achieving a single market for asset management.² Specific Issues We would like to discuss the following issues at the October 12 International Committee meeting. Please be prepared to provide us with your views about which issues the Institute should focus on.

- Burdensome Registration Process. Theoretically, under the UCITS Directive, a fund that has obtained authorization in one Member State would only have to "register" in other Member States in which it intends to market its shares. In reality, however, some 1 We understand that the review may be delayed until 2006 because the EU and the Member States are still grappling with implementation issues. 2 Memorandum to International Members No. 26-04 [17465] (May 6, 2004). 2 Member States impose requirements that routinely delay the 60-day waiting period set forth in the Directive. One alternative to the current system might be a "notice filing" regime. Would a "notice filing" system offer significant benefits over the current system? If so, how should such a system be developed to avoid the pitfalls of the current registration system?
- Structural Barriers to Growth. Currently, Europe has more funds than the US, and those funds are smaller than their US counterparts.
 - o Obstacles to Cross-Border Fund Mergers. One of the reasons for the relatively smaller size and greater number of funds in Europe is the difficulty in merging funds across European borders. Significant regulatory and tax barriers impede cross-border mergers. For example, some Member States require unanimous approval of shareholders for fund mergers or treat cross-border mergers as taxable events. What experience have Institute members had in merging funds in the EU? How important to members is the ability to merge EU funds cross-border?
 - o Difficulty in Creating Larger Asset Pools. Another reason it is difficult to create

larger asset pools in Europe is that the UCITS regulatory structure does not easily accommodate pooling assets from different distribution channels. Even under the new UCITS amendments, master-feeder funds are not permitted. Would the ability to pool assets be of significant benefit? What types of pooling are needed? Master-feeder? For what purposes are pooling important? Custody, investment management, and/or distribution? • Lack of EU-wide Private Placement Rules. There is no EU-wide law governing the private offering of funds in the European Union. The concept of private offerings is less developed than in the US, and in several European countries, private placements are not possible or are extremely difficult. This affects the ability of UCITS and non-UCITS funds that are registered in one EU Member State to sell their shares on a limited basis in other Member States. Is the ability to sell fund shares through private placements important to Institute members? • Fragmented Regulation of Asset Managers. There is a debate within the industry in Europe whether the EU should develop a comprehensive system of regulation of asset management. Currently, regulation of EU asset managers is fragmented under different directives. The UCITS Directive now provides for the regulation of UCITS managers; pension fund managers and individual portfolio managers (that do not manage UCITS funds) are regulated in the EU under the Directive on Markets in Financial Instruments (formerly known as the Investment Services Directive). Do Institute members have any views about this debate? • Regulation of Depositaries. The Commission is required to report on the regulation of depositaries. In a recommendation published in April 2004, the Commission found that depositaries are subject to a limited number of requirements at the EU level and that the vast majority of Member States have not developed more extensive rules than the 3 Directive's minimal provisions. Should there be EU-wide rules for the regulation of depositaries? If so, what elements should it include? • Capital Requirements. The UCITS amendments require the Commission to report on the new capital requirements in 2005, taking into account developments, "particularly those pertaining to capital charges on operational risk within the European Union and other international fora." The EU's capital adequacy regime for banks and investment firms is based on the Basel Accord, which is currently being revised to include, among others, operational risk charges. Although the current proposed amendments to the Capital Adequacy Directive would exempt UCITS managers from operational risk capital requirements, the Commission staff has indicated that operational risk charges may be applied to asset managers at some future time once there is more data on operational risk for the industry. How important for Institute members is the issue of capital requirements in asset management for operational risk? • Clearance and Settlement. The costs of clearing and settling fund shares cross border in Europe are significantly higher than in the US. This is in part due to the lack of standardization of operational protocols. Some fund associations in Europe believe this issue should be addressed first by the European industry. Do members agree? • Performance and Expense Reporting. There currently is no EU-wide standard for calculating performance. Investors, therefore, are not able to compare accurately the performance of UCITS funds domiciled in different EU jurisdictions. Moreover, although the EU simplified prospectus includes a total expense ratio, it is unclear whether the lack of uniform accounting rules across Europe applicable to funds would permit investors to compare accurately the expenses of UCITS funds from different Member States. Would standardized rules for performance and expense reporting in the EU be a significant benefit? If so, how can it be achieved? Are there any other issues on which you believe the Institute should focus? Jennifer S. Choi Associate Counsel

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