

MEMO# 20590

November 16, 2006

European Commission Publishes White Paper on Enhancing the Framework for Investment Funds in Europe

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20590] November 16, 2006 TO: INTERNATIONAL MEMBERS No. 30-06 INTERNATIONAL OPERATIONS ADVISORY COMMITTEE No. 34-06 RE: EUROPEAN COMMISSION PUBLISHES WHITE PAPER ON ENHANCING THE FRAMEWORK FOR INVESTMENT FUNDS IN EUROPE Yesterday, the European Commission published its highly anticipated White Paper on enhancing the framework for investment funds in Europe.¹ The White Paper sets out the views of the Commission on the current environment for funds in Europe and provides a roadmap of legislative and regulatory proposals that it intends to make in the next few years. A copy of the White Paper is attached. It is also available, along with a number of related documents, on the Commission's web site at http://ec.europa.eu/internal_market/securities/ucits/index_en.htm#061116. Background On July 14, 2005, the European Commission issued a Green Paper analyzing the fund market and regulatory framework in the EU and suggesting possible ways in the short and medium term to improve EU regulations to facilitate the development of the fund industry in Europe. The Institute submitted a comment letter in response to the Green Paper strongly supporting the Commission's efforts, but also suggesting a number of ways in which the cross-border market for funds in Europe could be improved.² 1 Commission of the European Communities, White Paper on Enhancing the Single Market Framework for Investment Funds, COM(2006)686, dated November 15, 2006 (the "White Paper"). 2 See Memorandum No. 19367, dated November 15, 2005. 2 Recommendations to Improve Efficiency In the White Paper, the Commission concludes that there is a significant need for improvement in the legislative and regulatory framework for funds in Europe. The Commission states: The UCITS Directive is no longer sufficient to support the European fund industry as it restructures to meet new competitive challenges and the changing needs of European investors. Core elements of the Directive are not functioning effectively. The freedoms conferred by the Directive come at the price of unnecessarily high compliance costs. It does not allow fund managers with funds or activities in different Member States sufficient flexibility to organise [sic] or restructure businesses. These inefficiencies and constraints are reflected in higher costs and lower returns that are borne by the fund investors. Independent research estimates that a reduction in European fund operating costs to US levels costs would boost nominal investment returns by 3%.³ As a result, the Commission proposes a number of legislative and non-legislative actions in the coming years to improve the efficiency of the fund industry in Europe. With respect to legislative

changes, the Commission will propose: 1. Amendments to improve the notification process that allows funds to be “passport” and sold on a cross-border basis in Europe;⁴ 2. Additional provisions to create the appropriate legal and regulatory conditions for the merger of funds; 3. Amendments to the diversification rules and other provisions of the Directive in order to allow an expansive approach to “entity pooling” to facilitate structures such as master- feeder funds; 4. Amendments to allow an authorized management company to manage corporate and contractual funds in other European member states (i.e., the management company passport); and 3 White Paper at 3. 4 Streamlining and simplifying the “fund passport” – the notification procedure that enables a fund to be sold outside of its home market – was the Institute’s primary recommendation in its comment letter on the Green Paper. 3 5. Proposals to strengthen the provisions of the UCITS Directive relating to competent authorities and supervisory cooperation. The Commission also makes recommendations in three areas that do not require changes to the UCITS Directive. These include: 1. Urging national authorities to expedite fund approvals and adhere to strict deadlines for authorization in the country of domicile; 2. Calling on the European industry to develop a coherent strategy to phase in the necessary improvements in message routing and fund order processing and settlement⁵; and 3. Recommending that Member States take a number of steps to remove barriers to choice and flexibility in the appointment of fund custodians. Recommendations to Make the Single Fund Market Work Better for Investors In the White Paper, the Commission also makes two significant recommendations intended to make the European fund market better for end investors. The first is to revisit efforts to create a workable simplified prospectus, including through amendments to the UCITS Directive to clarify the fundamental objectives and guiding principles of the simplified prospectus and by revisiting the Commission’s recommendation to enhance risk, cost and performance disclosures.⁶ The second is to carefully monitor the implementation of MiFID rules on “conduct of business” and inducements in respect of intermediated fund sales. In this regard, the Commission notes that: At present, fund managers will pay on average 50% of their management fee to a third party distributor. It needs to be examined whether such commissions constitute payment for services rendered such as pre/after-sales service to clients. Conflicts of interest and inducements must be properly managed or disclosed: intermediaries 5 The portion of the White Paper on this point may be of particular interest to members of the International Operations Advisory Committee. The Commission states that: Fund order-processing has not kept pace with the growth of the market, and changes in distribution systems. It is characterised [sic] by higher operational risks, longer processing delays and, inevitably, higher costs. However, these inefficiencies are not rooted in regulation or public sector intervention – but arise from private sector inertia and the difficulties of coordinating a transition to superior technologies or more efficient business models. The Commission calls on the European industry to develop a coherent strategy to phase in the necessary improvements in these functions. White Paper at 9. 6 The Commission’s assessment of the current European effort to create a simplified prospectus was particularly negative, stating that the effort has “manifestly failed” and resulted in “a massive paper-chase of limited value to investors and a considerable overhead for the fund industry.” White Paper at 10. 4 must diligently undertake duties of care to the retail client.⁷ Other Recommendations In addition to the steps outlined above, the White Paper discusses the Commission’s intentions on two additional topics: non-harmonized (i.e., non-UCITS) retail products and the marketing and sale of products to “qualified investors.” The White Paper states that the Commission will study the likely costs, benefits and risks of providing a single market framework for non-harmonized retail products, with an expectation that it will publish a report on that topic in 2008. With respect to “qualified investors,” the White Paper states that the Commission will study the types of marketing and sales restrictions that should be repealed in favor of reliance on the investment firms exercising

responsibility for the sale of products on a client-by-client basis, and also will undertake a systematic inventory and analysis of national barriers to the private placement of financial instruments with institutional investors and other eligible counterparties. The Commission expects to be able to report on this topic by the fall of 2007. * * * * * Robert C. Grohowski Senior Counsel - International Affairs Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 20590, or call the ICI Library at (202) 326-8304 and request the attachment for memo 20590. 7 White Paper at 11.

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