

## European Commission Issues White Paper Identifying Areas for Improvement for UCITS Framework

### Summary

On November 15, 2006, the European Commission ("EC") issued a white paper (the "White Paper") expressing its views on ways to simplify the existing European Union ("EU") framework for investment funds while providing attractive and secure investments for investors.<sup>1</sup> The White Paper highlights certain EC proposals that would support a more efficient European fund industry and address the changing needs of European investors.

Generally, the UCITS Directive<sup>2</sup> provides the regulatory framework for the European investment fund industry. Investment funds that are organized pursuant to the UCITS framework may generally be "passported" into EU member states ("Member States") for sale to retail investors, provided that certain notification and other requirements are satisfied. In July 2005, the EC issued a green paper analyzing the European investment fund market and related regulatory framework (the "Green Paper").<sup>3</sup> The Green Pa-

per identified several shortcomings in the existing regulatory framework and suggested additional regulatory measures that, if successfully implemented, could improve the efficiency of the European fund industry and facilitate its growth.

In building on industry response to the Green Paper, the White Paper was developed on the basis of extensive consultation and debate with consumers, industry practitioners, and policy-makers over a period of two years. The White Paper finds that "the UCITS Directive is no longer sufficient to support the European fund industry" and that additional regulatory improvements are necessary to foster further growth in the industry. Specifically, the White Paper identifies certain challenges facing the current regulatory framework, including:

- *A widening gap between the UCITS sector and market reality:* the EC found that many retail investment funds are unable to comply with the investment rules of the UCITS Directive, and therefore are only available on a national, rather than cross-border, basis
- *The role of investment fund managers in providing individuals with options to save for retirement:* the EC foresees the challenge in creating new investment products that will transform retirement savings into a predictable and secure income source

<sup>1</sup> Commission of the European Communities, *White Paper on Enhancing the Single Market Framework for Investment Funds*, SEC (2006) 1451, SEC (2006) 1452, COM (2006) 686 (Nov. 15, 2006).

<sup>2</sup> Council 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 by, among others, Directives 2001/107/EC and 2001/108/EC of the European Parliament and Council.

<sup>3</sup> Commission of the European Communities, *Green Paper on the Enhancement of the EU Framework for*

*Investment Funds*, SEC (2005) 947, COM (2005) 314 (Jul. 12, 2005).

- Competition from other forms of financial products: the EC recognizes that many market participants believe that it is more expensive and restrictive to manage a UCITS fund than to sell other types of investment products—such as unit-linked life insurance or structured notes and certificates; however, the EC does not believe the answer to this issue lies with extending UCITS-type regulation to all types of long-term European savings products
- *Global competition*: the EC noted that while the European fund industry is exporting its know-how to other regions of the world, competition from external fund jurisdictions is starting to build and the EU will need to adapt to stay at the forefront

The EC noted that it intends to propose several legislative and non-legislative actions over the next several years to meet these challenges. Specifically, the White Paper proposes to build on the existing UCITS framework and proposes to modernize and complement it in several areas, notably by eliminating procedures and costs that do not materially enhance investor protection. The White Paper recognizes the uncertainty about the appropriateness of the scope and design of the present UCITS Directive, and concludes, on balance, that there are insufficient grounds to undertake a fundamental revision of the UCITS Directive at this time. The White Paper also concludes, however, that action must be taken to:

- Strengthen the cross-border marketing of UCITS, thereby enabling the fund industry to serve European and global investors more efficiently
- Ensure that investors are in a position to make informed decisions and rely on qualified intermediaries for objective expert advice
- Assess whether a single market framework should be created to allow cross-border sale of some types of non-UCITS funds to retail investors
- Establish a “private placement” regime to facilitate the sale of non-harmonized funds and financial instruments to institutional and sophisticated investors in other Member States

## Discussion of the White Paper

### Building on the Existing UCITS Framework

The White Paper proposes to increase the effectiveness of the current UCITS framework as it relates to the cross-border marketing of UCITS funds. As discussed below, these actions would generally require cooperation between regulatory authorities in Member States and increased supervision of these authorities by the EC.

#### *Passporting Procedures – UCITS Funds*

As noted above, a UCITS fund may be offered and sold to retail investors in any Member State provided that the fund manager has filed certain documentation with the relevant local authority in the Member State. Once these materials have been filed with the local authority, the fund is typically required to wait two months to receive approval from the local regulator. The Green Paper expressed concern with the “bottle-necks” and failures of this registration process that have resulted in increased costs and supervisory interference, ultimately hampering the introduction of new products on a pan-European basis.

In response to the EC’s concern, many have suggested that the EC implement measures that would, among other things, shorten the two-month waiting period, require only simple translations of documents (i.e., no certified translations), harmonize and reduce notification fees, and require notification for only those sub-funds or share classes proposed to be marketed in a Member State.

To address the inefficient nature of the passporting process, the EC will introduce targeted adjustments to existing passporting mechanisms to simplify the process and will work to enhance supervisory cooperation to facilitate the cross-border marketing of UCITS funds. Among these adjustments would be the requirement that (i) documentation and other exchanges be made on a regulator-to-regulator basis (e.g., a potential host country regulator would obtain certain documentation and other information directly from an applicant’s home country regulator or other relevant regulator), and (ii) the local selling intermediary be primarily responsible for compliance with local marketing and advertising rules.

### *Passporting of Management Companies*

Under the existing UCITS framework, management groups are generally required to establish a fully functional management company in each country where they organize a fund. These management companies are then required to comply with the local law of the Member State where they are domiciled, resulting in increased costs and regulatory burdens. While the EC adopted the concept of a management company passport in its 2001 amendments to the UCITS Directive, the directive created certain ambiguities regarding the management company passport that the EC now wishes to resolve.

The White Paper states that the EC will propose amendments to the UCITS Directive that would allow management companies of contractual and corporate funds to be passported in Member States. Under this arrangement, a management company would be permitted to manage a UCITS fund domiciled in a Member State other than its home jurisdiction.

Although the ability of management companies to be passported across Member States would decrease certain industry costs, the EC cautions that such an amendment would require careful consideration of the scope of passportable services and applicable tax consequences. Further, the EC recognizes that passporting management companies could raise supervisory and investor protection concerns by fractioning the supervisory oversight of a management company across multiple regulators.

### *Cross-Border Mergers and Asset Pooling*

The Green Paper identified several impediments to the exploitation of cost efficiencies and synergies in the management of European investment funds. According to the EC, the European fund marketplace is crowded with many small funds which hinder the industry from fully benefiting from economies of scale.<sup>4</sup> While the Green Paper recognized that the UCITS Directive does not prevent cross-border mergers of funds, which is one method to increase economies of scale in the industry, it does not address the practical obstacles to such mergers, including differing tax and corporate law regimes, that make such mergers difficult.

<sup>4</sup> Approximately 54% of UCITS funds have less than EUR 50 million in assets under management. See White Paper.

The White Paper reiterates the EC's desire to facilitate cross-border fund mergers. Consequently, the EC states that it will propose additions to the UCITS Directive to create the appropriate legal and regulatory conditions for cross-border fund mergers. Such provisions would include advance disclosure to fund shareholders and a free redemption period. With respect to the taxation of cross-border mergers, the EC suggests utilizing existing case law of the European Court of Justice to issue an EC Communication clarifying that national tax-neutral arrangements should be extended to mergers involving funds domiciled in a Member State. This approach, according to the EC, is preferable to seeking the unanimous support of Member States to adopt tax harmonization proposals.

The Green Paper also discussed "asset pooling" as a possible means to achieve greater efficiency within the industry. Under an asset pooling arrangement, legally separate funds would be collectively managed and/or administered by feeding their assets into a master fund ("entity pooling") or by using information technology to manage the funds side-by-side ("virtual pooling"). In responding to the Green Paper's discussion of cross-border mergers and asset pooling, many commentators generally showed support for the implementation of measures designed to facilitate such activities.

The EC will propose amendments to the diversification rules and certain other provisions of the UCITS Directive in order to allow an extensive approach to entity pooling, which is currently prohibited under the diversification requirements of the UCITS Directive. The EC also states that it will explore the viability of virtual pooling techniques and the need for any legislative action to provide an administrative framework for such structures.

### **Making the Single Market Work for Investors**

The White Paper identifies certain improvements that should be made to the UCITS Directive to ensure that a single market works for investors. As discussed below, the EC will revisit the use of a simplified prospectus by UCITS funds and the manner in which such funds are ultimately sold to end investors.

#### *Simplified Prospectus*

Under the current regulatory framework, UCITS funds are required to issue a simplified prospectus that serves as both a marketing piece and a disclosure document. The simplified prospectus requirement is

designed to disclose key information about a fund to investors in a manner that is easy for them to understand. After the Green Paper's release, several commenters indicated that the simplified prospectus was not meeting its objectives, in part due to the inconsistent implementation of the UCITS Directive requirements across Member States.<sup>5</sup> Further, commenters stated that the simplified prospectus was a lengthy document, that in the case of umbrella-type funds, exceeded the length of a fund's full prospectus in some cases.

In response to such concerns, the EC proposes a two-level approach. Over the longer term, the EC proposes to amend the UCITS Directive to clarify the fundamental objectives of the simplified prospectus and to allow for the adoption of legally binding implementing measures to allow for uniform application by Member States. Over the short-term, the EC plans to revisit the Recommendation to enhance risk, cost, and performance disclosures. The EC plans on carrying out this task in close association with the Member States and investors, distributors, and industry participants.

#### *Distribution Systems*

The Green Paper highlighted the need for clarification with respect to the offering, sale, and promotion of UCITS funds in Member States resulting from industry trends, including changing investor needs and the opening of distribution channels to third party products. Further, the EC recognizes that the distribution end of the value chain is a major cost-center in the European fund industry, particularly with respect to the cross-border sale of UCITS funds. When responding to the Green Paper, commenters noted that there was a need for greater competition in distribution channels that were dominated by in-house networks. According to the commenters, such competition would increase investor protection through allowing better comparability between funds.

<sup>5</sup> The EC issued a Recommendation (2004/384/EC) on April 27, 2004, to clarify the implementation of the simplified prospectus requirements set forth in the UCITS Directive. However, EC Recommendations are not legally binding in nature and, as a result, are not necessarily uniformly implemented across Member States.

The White Paper states that MiFID<sup>6</sup> should underpin the quality of client support that advisors, brokers, and other intermediaries provide to clients contemplating investments in funds. The EC will carefully monitor the implementation of MiFID's rules governing conduct of business and inducements with respect to fund sales by intermediaries. The EC proposes to publish a handbook to consolidate the effective implementation of these provisions in order to ensure that investors can count on objective and professional fund intermediation.

#### **Single Market for Non-Harmonized Retail Funds**

The current UCITS framework does not cover the full range of investment funds that can be marketed to retail investors in individual Member States (e.g., open-ended real estate funds). The EC estimates that such funds account for approximately 10% of total assets under management in the EU. Because such funds are outside the scope of the UCITS framework, they may not be passported to other Member States.

The White Paper introduces the possibility of adopting a formal framework to support the cross-border retail sale of such funds. However, it also identifies several issues implicated by such a regulatory regime, including whether (i) the risk and performance characteristics of these types of funds are broadly suited to retail investors, and (ii) the ability to passport these types of funds delivers meaningful benefits to this sector of the industry, investors, and the wider marketplace. The EC plans to further explore the likely costs, benefits, and risks of providing an enabling single market

<sup>6</sup> Directive 2004/39/EC of the European Parliament and Council on markets in financial instruments, amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and Council, and repealing Council Directive 93/22/EEC. MiFID governs the passporting of investment services and activities in Member States and generally: (i) applies detailed conduct of business rules to firms subject to its provisions (these rules include, *inter alia*, the requirement that a firm's compliance function be operated independently, certain marketing and advertising restrictions, and certain disclosure requirements); (ii) applies new transparency principles to equity dealing; and (iii) expands the range of "core" investment services and activities to include investment advice, commodities broking, and multilateral trading facilities, which will be entitled to be passported in Member States. Firms that will be subject to MiFID include, but are not necessarily limited to, broker-dealers, asset managers, and corporate finance advisers. Member States are expected to comply with MiFID by November 1, 2007.

framework for non-harmonized (non-UCITS) retail funds and to further consider the issues previously described. The EC plans to report to the EU Council and Parliament on its conclusions in 2008.

### Pan-European Private Placement Regime

With respect to private equity funds, hedge funds, and other alternative investment products that are generally marketed to institutional, rather than retail, investors, the Green Paper recognized that there is no common European approach to distinguish products that are suitable for retail investors from those that should solely be directed at sophisticated investors. In their comments to the Green Paper, several commenters had indicated that such regulatory fragmentation impaired market access for alternative products across Member States.

In response, the EC proposes to study the types of marketing and sales restrictions currently in place across Member States that should be repealed in favor of relying on investment firms to make appropriate suitability determinations, on a client-by-client basis, under MiFID. Further, the EC will establish an inventory of the national rules and restrictions governing

the private offer of alternative products to institutional investors and other sophisticated persons. The White Paper noted that there are no compelling investor protections reasons for national regulators to interfere in financial transactions involving professional investors that understand the risk associated with an investment. The EC proposes to work toward establishing a common private placement regime across Member States to facilitate the cross-border sales of alternative investment products.



This update was authored by Karen L. Anderberg (+44 20 7184 7313; karen.anderberg@dechert.com), Christopher D. Christian (+1 202 261 3321; christopher.christian@dechert.com), Robert W. Helm (+1 202 261 3356; robert.helm@dechert.com), Angelo Lercara (+49 89 21 21 63 22; angelo.lercara@dechert.com), Marc Seimetz (+352 45 62 62 23; marc.seimetz@dechert.com), Nauman Malik (+1 202 261 3387; nauman.malik@dechert.com), and Antonios Nezeritis (+352 45 62 62 27; antonios.nezeritis@dechert.com).

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## Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at [www.dechert.com/financialservices](http://www.dechert.com/financialservices).

**Karen L. Anderberg**  
London  
+44 20 7184 7313  
karen.anderberg@dechert.com

**Stephen H. Bier**  
New York  
+1 212 698 3889  
stephen.bier@dechert.com

**Douglas P. Dick**  
Newport Beach  
+1 949 442 6060  
douglas.dick@dechert.com

**Margaret A. Bancroft**  
New York  
+1 212 698 3590  
margaret.bancroft@dechert.com

**Christopher Christian**  
Washington, D.C.  
+1 202 261 3321  
christopher.christian@dechert.com

**Steven Drachman**  
New York  
+1 212 698 5627  
steven.drachman@dechert.com

**Allison R. Beakley**  
Boston  
+1 617 728 7124  
allison.beakley@dechert.com

**Timothy M. Clark**  
New York  
+1 212 698 3652  
timothy.clark@dechert.com

**Jennifer O. Epstein**  
London  
+44 20 7184 7403  
jennifer.epstein@dechert.com

**Sander M. Bieber**  
Washington, D.C.  
+1 202 261 3308  
sander.bieber@dechert.com

**Elliott R. Curzon**  
Washington, D.C.  
+1 202 261 3341  
elliott.curzon@dechert.com

**Ruth S. Epstein**  
Washington, D.C.  
+1 202 261 3322  
ruth.epstein@dechert.com

**Susan C. Ervin**

Washington, D.C.  
+1 202 261 3325  
susan.ervin@dechert.com

**Joseph R. Fleming**

Boston  
+1 617 728 7161  
joseph.fleming@dechert.com

**Brendan C. Fox**

Washington, D.C.  
+1 202 261 3381  
brendan.fox@dechert.com

**Wendy Fox**

Washington, D.C.  
+1 202 261 3390  
wendy.fox@dechert.com

**David M. Geffen**

Boston  
+1 617 728 7112  
david.geffen@dechert.com

**David J. Harris**

Washington, D.C.  
+1 202 261 3385  
david.harris@dechert.com

**Robert W. Helm**

Washington, D.C.  
+1 202 261 3356  
robert.helm@dechert.com

**Jane A. Kanter**

Washington, D.C.  
+1 202 261 3302  
jane.kanter@dechert.com

**Stuart J. Kaswell**

Washington, D.C.  
+1 202 261 3314  
stuart.kaswell@dechert.com

**Angelo Lercara**

Munich  
+49 89 21 21 63 22  
angelo.lercara@dechert.com

**George J. Mazin**

New York  
+1 212 698 3570  
george.mazin@dechert.com

**Jack W. Murphy**

Washington, D.C.  
+1 202 261 3303  
jack.murphy@dechert.com

**John V. O'Hanlon**

Boston  
+1 617 728 7111  
john.ohanlon@dechert.com

**Fran Pollack-Matz**

Washington, D.C.  
+1 202 261 3442  
fran.pollack-matz@dechert.com

**Jeffrey S. Poretz**

Washington, D.C.  
+1 202 261 3358  
jeffrey.poretz@dechert.com

**Jon S. Rand**

New York  
+1 212 698 3634  
jon.rand@dechert.com

**Robert A. Robertson**

Newport Beach  
+1 949 442 6037  
robert.robertson@dechert.com

**Keith T. Robinson**

Washington, D.C.  
+1 202 261 3386  
keith.robinson@dechert.com

**Alan Rosenblat**

Washington, D.C.  
+1 202 261 3332  
alan.rosenblat@dechert.com

**Frederick H. Sherley**

Charlotte  
+1 704 339 3100  
frederick.sherley@dechert.com

**Marc Seimetz**

Luxembourg  
+352 45 62 62 23  
marc.seimetz@dechert.com

**Joseph J. Smallhoover**

Paris  
+33 1 5365 0517  
joseph.smallhoover@dechert.com

**Patrick W. D. Turley**

Washington, D.C.  
+1 202 261 3364  
patrick.turley@dechert.com

**Brian S. Vargo**

Philadelphia  
+1 215 994 2880  
brian.vargo@dechert.com

**David A. Vaughan**

Washington, D.C.  
+1 202 261 3355  
david.vaughan@dechert.com

**Anthony H. Zacharski**

Hartford  
+1 860 524 3937  
anthony.zacharski@dechert.com

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