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**WHITE PAPER**

**WHITE PAPER ON ENHANCING THE SINGLE MARKET FRAMEWORK FOR  
INVESTMENT FUNDS**

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{SEC(2006) 1452}

## Introduction:

Investment funds provide retail investors with access to professionally managed and diversified investments on affordable terms. European investors will need a capable and well-regulated asset management business as the ageing of society requires them to take more responsibility for their long-term financing needs. This is already driving huge growth in this business – within Europe and globally. Institutional investors, including funds, are responsible for a growing share of household investment in all G-10 countries. Investment funds account for 12.6% of European household financial assets.<sup>1</sup> EU investment funds have experienced five-fold growth in assets under management over the space of 12 years. Growth rates of around 10% per annum are expected in the period to 2010 - bringing total assets under management by funds to over 8 trillion€. The cornerstone of the EU framework for investment funds is the 1985 UCITS Directive. The UCITS Directive<sup>2</sup> has provided the focal point for the growth of a vibrant European fund industry. This market is increasingly organised on a pan-European basis. The UCITS product passport is in widespread use. Cross border fund sales represented some 66% of the total net industry inflows in 2005.

The challenge for EU policymakers is to ensure that this regulatory framework remains effective in the face of changing market dynamics and investor needs. Profound structural changes in European financial markets are putting new strains on the UCITS regulatory system. This White Paper sets out the views of the European Commission on ways to simplify the European legislative environment while providing attractive and secure investment solutions to investors.

### **Box: Investment funds, UCITS and non-UCITS:**

**Investment funds** are specially constituted investment vehicles, created with the sole purpose of gathering assets from investors, and investing those assets in a diversified pool of assets. Investors buy securities issued by the fund against the underlying assets, and the value of those securities fluctuates with the value of the underlying assets. In this way, small investors can buy exposure to a professionally managed and diversified basket of financial or other assets. Overheads are spread over the pool of investors, reducing average cost for the investor. Investors may be able to sell their shares back to the open when they want (open-ended funds) or their assets may be locked up for a fixed period (closed-end).

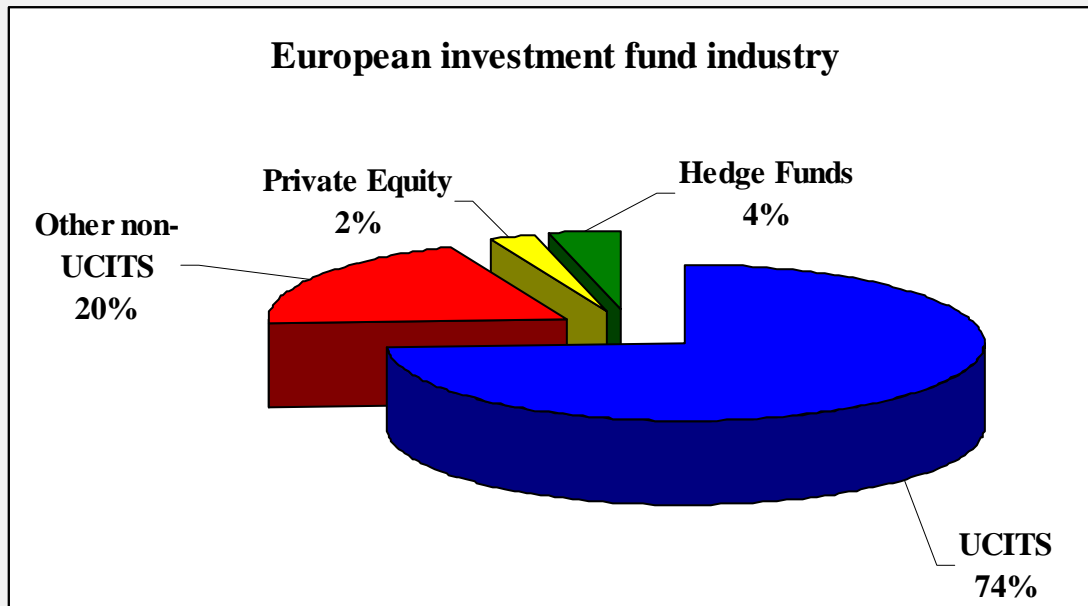
**UCITS (Undertakings for Collective Investment in Transferable Securities)** are investment funds established and authorised in conformity with the requirements of Directive 85/611/EEC. This Directive lays down common requirements for the organisation, management and oversight of the fund. It imposes rules relating to fund diversification, liquidity and use of leverage. The UCITS Directive defines a list of eligible assets in which the fund can invest. Once authorised, a UCITS fund can be marketed to the public across the EU subject to notification in each Member State where it is sold.

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<sup>1</sup> EFAMA Fact Book, 2006.

<sup>2</sup> Directive 85/611/EEC of Council as amended by Directives 2001/107/EC and 2001/108/EC of the European Parliament and Council.

**"Non UCITS"** is a catch-all term referring to all non-harmonised funds whether subject to national regulation or not. This comprises a wide range of investment styles and products – ranging from retail-oriented products such as open-ended real estate funds to more volatile products such as commodity and private equity funds.



***Introducing greater efficiency in the current framework:***

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 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%.<sup>3</sup> The steps envisaged in this White Paper are of potentially significant importance to the millions of households which have invested in funds. For these benefits to trickle down to end-investors, there will be a need for effective competition all along the fund value chain.

***Tackling broader challenges:***

The current EU framework is faced with new challenges to its scope and approach:

- (1) **There is a widening gap between the UCITS sector and market reality:** Many retail funds cannot comply with the prescriptive investment rules of the Directive: they are available to retail investors at national level but not cross-border. The Directive has already been amended once to include a wider range of investment policies. The Commission is currently clarifying whether a wider range of investments policies are compatible with the Directive provisions. However,

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<sup>3</sup> CRA (2006).

continued innovation means that we are continually forced to revisit this issue. The White Paper foresees a systematic review of investment rules and fund performance used by both harmonised and non-harmonised funds.

- (2) **Investment fund managers will be in the front-line in providing individuals with options to save for retirement.** Investment funds provide an established vehicle for accumulating capital throughout working life. The challenge now is to transform those savings into a predictable and secure income for investors in retirement. The race to develop those products is on.
- (3) **Competition from other forms of financial product.** Many market practitioners argue that it is more expensive and restrictive to manage a UCITS fund than to sell other types of investment product – such as (unit-linked) life insurance or structured notes and certificates. Because of different regulatory and product features, this is like comparing apples and pears. The Commission does not believe that the answer lies in extending UCITS-type regulation to all long-term savings vehicles. It does see a need for constant regulatory engagement to ensure that all investment products are sold subject to clear rules that protect investors from excessive charging or mis-selling. The Commission will publish the result of market research on this point in mid 2007.
- (4) **Meeting the challenge of global competition.** UCITS authorisation has won wide global recognition as a guarantee of sound product structuring and effective regulation. An innovative and soundly regulated European fund industry is already exporting its know-how to other regions. However, competition from other fund jurisdictions is starting to build. Constant efforts will be needed to remain in the global vanguard.

#### ***Building on the existing framework:***

This White Paper foresees a progressive development of the existing framework. It proposes to modernise and complement it in a number of specific and targeted areas – notably by eliminating procedures and costs that do not materially enhance investor protection. It recognises uncertainty about the appropriateness of the scope and design of the present Directive. It concludes that, on balance, there are insufficient grounds to undertake a fundamental revision of the Directive at this stage. Instead, it envisages a structured review of the need for changes to the scope and regulatory approach of the Directive as the contours of the fund market evolve.

The White Paper foresees actions to:

- (1) Strengthen single market freedoms, thereby enabling the fund industry to serve European and global investors more efficiently;
- (2) Ensure that investors are in a position to make informed investment decisions and rely on qualified intermediaries for objective expert assistance;
- (3) Assess whether a single market framework should be created to allow the cross-border sale of some types of non-UCITS to retail investors and how this could most effectively be done;

- (4) Launch work on a European 'private placement' regime to facilitate the sale of non-harmonised funds and financial instruments to institutional and sophisticated investors in other Member States.

This White Paper has been developed on the basis of extensive consultation and debate with consumers, industry practitioners and policymakers over a period of two years. It builds on responses to the Commission Green Paper of July 2005<sup>4</sup>; three reports from specially-constituted industry expert groups and stakeholder responses<sup>5</sup>; series of ad hoc initiatives including two workshops on simplified prospectus. It also responds directly to the important concerns raised in the report of the European Parliament. The steps proposed in this White Paper have also been the object of rigorous impact assessment.

## **1. SUPPORTING A MORE EFFICIENT EUROPEAN FUND INDUSTRY:**

In July 2005, the Commission Green Paper identified the following shortcomings in the existing legislative framework:

- Bottlenecks and failures of the product passport. Procedures for cross-border marketing take too long, are too costly and subject to too much supervisory interference;
- Sub-standard investor disclosures: the simplified prospectus does not help investors or their advisors to make sound investment decisions.
- Proliferation of small inefficient funds: The Directive provides no mechanisms to facilitate the amalgamation of funds or pooled management of assets. The European fund market is populated by small and relatively expensive funds, driving up costs.
- Obstacles to functional and geographic specialisation. The Directive requires concentration of all value chain activities in one Member State: only the fund can be 'pass-ported'. These legislative restrictions prevent the fund industry from taking full advantage of all locational and specialisation benefits on offer in the single market.

The Commission services have examined these supply-side inefficiencies and assessed the positive and negative impacts of different options for their removal. The impact assessment provides a clear-cut expectation that action on a number of areas will deliver benefits which outweigh costs or risks of action. It also finds little evidence in support of a number of actions. This section introduces those points where the Commission will quickly come forward with proposals to change the existing Directive. Some of these freedoms are complementary. They provide fund managers and administrators a menu of options for harnessing the efficiency benefits of a single market through a number of business models.

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<sup>4</sup> COM(2005) 314 , final, 14.07.2005.

<sup>5</sup> Reports of the expert group on investment fund market efficiency and the expert group on alternative investments (hedge funds and private equity). Reports and conclusions of an open hearing on these reports are available at [http://ec.europa.eu/internal\\_market/securities/ucits/](http://ec.europa.eu/internal_market/securities/ucits/).

## **1.1. Removing administrative barriers to cross-border marketing:**

Before marketing a fund in another Member States, the UCITS Directive requires the fund manager to file extensive documentation with the relevant local authority and wait for two months while the latter verifies compliance with local advertising rules. The deadline of two months is not always respected. Cases have been reported where it has taken eight to nine months to complete the notification process. There are few identifiable benefits from the present notification system. It is a pure cost for market participants. It severely hampers the roll-out of new products across the single market.

Extensive efforts to remove the most important sources of administrative friction have been undertaken, culminating in CESR<sup>6</sup> guidelines in June 2006. However, these worthy improvements cannot overcome the administrative and procedural obstacles that have their origin on outmoded provisions of the Directive.

The Commission will table proposals to amend Articles 44-47 of the Directive. The existing administrative procedures that must be satisfied before a fund can be marketed in another Member State – notably detailed ex-ante verification of fund documentation by the host authority and the current 2 month maximum waiting period - will be scaled back. Documentation and other exchanges shall take place on a regulator-to-regulator basis. Supervisory-cooperation mechanisms will be introduced to ensure speedy resolution of identified problems. Host supervisors should focus compliance with local marketing and advertising rules on the intermediaries directly responsible for those activities in the host jurisdiction rather than the partner country fund manager.

## **1.2. Facilitating cross-border fund mergers.**

The UCITS market is populated by funds of sub-optimal size: some 54% of UCITS funds have less than 50million€ in assets under management. Consequently, important economies of scale remain unexploited and the end investor bears unnecessarily high costs. Research has estimated that costs could be annually reduced by 5-6 billion€

In the absence of a facilitating EU framework, fund mergers are complex, time consuming and expensive – where at all possible. Cross-border fund mergers are faced with particular hurdles – arising from differences between national legal and supervisory arrangements. In 2005, only 3.5% of mergers were cross-border. Cross-border fund mergers should not give rise to adverse tax consequences for investors. Many Member States already operate tax arrangements which ensure that mergers between domestic funds take place in a tax-efficient way. It is essential to ensure that such benefits are extended to mergers involving funds from another Member State.

The Commission will propose additions to the UCITS Directive to create the appropriate legal and regulatory conditions for the merger of funds. These provisions will ensure that fund mergers take full account of the needs of investors in the merging funds. There will in particular be a need to ensure effective advance disclosure on the merger and to

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<sup>6</sup> Committee of European Securities Regulators

provide the possibility for the unit-holder to redeem free of charge.

As far as taxation of cross-border UCITS mergers is concerned<sup>7</sup>, the Commission considers it preferable to build on relevant case-law of the European Court of Justice. This route seems more promising than tabling proposals for tax harmonisation which will require unanimous support of 27 Member States. On the basis of European Court of Justice (ECJ) case-law, the Commission will come forward with a Communication to clarify that national tax-neutral arrangements should be extended to mergers involving funds domiciled in another Member State.

### **1.3. Asset pooling<sup>8</sup>:**

Asset pooling allows simultaneous management of assets gathered by different funds – while maintaining a local fund presence in different target markets. The skills and costs of successful management teams can be spread over a wider pool of assets. These techniques are not only relevant for investment funds but also as a possible model for pension funds. Pooling is increasingly used in some Member States. However, there are significant barriers to cross-border asset pooling.

A technically and legally straightforward approach to 'asset pooling' is known as 'entity pooling'. This approach is currently ruled out by the diversification requirements of the UCITS Directive. However, there is a strong support and extensive experience regarding some entity pooling structures (e.g. master-feeders). A second approach, known as 'virtual pooling', does not require the legal transfer of assets to a receiving fund. But it places heavy demands on fund administration and back-office functions. Some regulators have reservations about this relatively new and untested technique – particularly as regards transparency and contract enforceability, but also as regards robustness of IT and risk management controls.

The Commission will propose amendments to the diversification rules and other provisions of the Directive in order to allow an expansive approach to 'entity pooling'. In preparing legislation, the Commission will also further explore the soundness of virtual pooling techniques and the need for Directive amendments to provide legal certainty and underpin effective management and supervision of such structures.

### **1.4. Management company passport:**

Currently, management groups need to establish a fully functional management company in each country where they domicile a fund: these must satisfy costly local substance requirements. This pushes up costs and prevents scale and specialisation gains. The 2001 amendment failed to introduce an effective management company passport for corporate funds. It is time to complete this unfinished business and to extend these rights to

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<sup>7</sup> Most UCITS do not qualify for the "Tax merger Directive" (Council Directive 90/434/EEC)

<sup>8</sup> Asset pooling refers to the aggregation of assets of different investment funds with a view to co-managing those assets as a single pool – thereby reaping scale, liquidity and other trading benefits. Pooling can take the form of 'entity pooling'. The assets of participating funds are aggregated in a separate legal entity. Master-feeder structures are a form of entity pooling in which the feeder funds transfer all assets received to the master fund. Virtual pooling uses information technology to aggregate the assets of participating funds as if there were an underlying pool, but without constituting the pool as a legal entity.



contractual funds. The Commission is confident that solutions can be found to meet supervisory concerns about splitting responsibility for supervision of fund administration from fund management. There will be a need for careful consideration of the scope of pass-portable management services and attention to ensure that the management company passport does not complicate the tax-efficient structuring of the fund chain. The management company passport should not empty control in the country of domicile of all substance. This would undermine effective oversight of the fund by the depositary – one of the mainstays of investor protection in the UCITS Directive.

The Commission will propose amendments to the Directive to allow an authorised management company to manage corporate and contractual funds in other Member States. The scope of passport-able services will need to be carefully tested and validated during the preparatory phase.

### **1.5. Strengthening supervisory cooperation:**

The above changes to the single market framework for investment funds will pave the way for cross-border operations, platforms or structures which may be legally and technically more complex. Different enforcement authorities may be responsible for different actors in the reconstructed value chain. Effective supervision of cross-border structures and functions will need to be underpinned by full and timely cooperation between the relevant national authorities. For example, the desired streamlining of fund notification procedures will be accompanied by provisions imposing an obligation on the fund's home authority to respond effectively to partner country concerns in a timely fashion. Other amendments – such as a management company passport, pooling structures and mergers – will all require clear specification of respective responsibilities of different supervisory authorities, and clarification of the duties that the different supervisors owe to their colleagues. This will increase confidence in the soundness of cross-border structures. The Commission is confident that effective supervisory cooperation can be found for UCITS as they have been found for other sensitive areas of securities law enforcement (e.g. market abuse). The CESR expert group on investment management is already proving its worth as an effective network for finding pragmatic solutions to common supervisory challenges.

The Commission will table proposals to strengthen the provisions of the UCITS Directive relating to competent authorities and supervisory cooperation. Amendments will be modelled on the relevant provisions of more recent securities legislation (e.g. MiFID<sup>9</sup> and the Prospectus Directive). Enforcement authorities will be required to provide timely assistance and intervene where necessary in the event of difficulties originating in their jurisdiction. They must be equipped with comparable powers when it comes to pursuing and punishing improper conduct by fund managers.

### **1.6. Efficiency improvements that do not require changes to the Directive:**

- **Strict deadline for authorisation in country of domicile:** Delays of six weeks before obtaining UCITS authorisation are not uncommon. This constitutes a significant disadvantage for UCITS compared to other investment products and individual

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<sup>9</sup> Markets in Financial Instruments Directive 2004/39/EC of 21 April 2004

securities. The Commission therefore urges national authorities to expedite fund approvals. However, there is no need for the EU legislator to intervene. 'Competition between systems' should be allowed to operate. Those national authorities with an interest in building a successful domestic fund business have a clear incentive to implement efficient and reliable authorisation procedures.

- **Message routing and fund order processing/settlement:** Fund order-processing has not kept pace with the growth of the market, and changes in distribution systems. It is characterised 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.
- **Depositary passport:** The freedom to appoint a depositary in another Member State does not seem to hold out the prospect of significant gains. Depositary functions account for a low proportion of total fund costs and potential gains have been largely exhausted through extensive use of delegation. Any marginal benefits seem to be considerably outweighed by the scale of adjustments that would need to be undertaken to the Directive to harmonise the responsibilities and functions of the depositary. The Commission will recommend that Member States take a number of steps to remove barriers to choice and flexibility in the appointment of fund custodians. In particular, the Commission will urge Member States to allow branches from banks authorised in another Member State to act as depositaries; and to allow depositaries to delegate assets' safekeeping to a custodian in another Member State. In the longer-term, Commission services will continue their monitoring of the depositary market in order to assess the necessity for greater flexibility and/or harmonisation.

In these and other areas, the Commission urges Member States to review practices in respect of fund authorisation and supervision to identify ways where improvements can be introduced on a unilateral basis, having regard to 'best practices' elsewhere in the EU. While some of the impetus for a successful and vibrant fund industry will come from EU-level developments, there are many steps that individual Member States can take to improve their domestic operating environment for investment funds.

## **2. MAKING THE SINGLE FUND MARKET WORK FOR THE END-INVESTOR:**

Cost-savings and new market openings for the industry must translate into tangible improvements for the end-investor – in the form of lower charges or higher returns but also in terms of access to continued enhancements in product performance. For this to happen, industry will need to be subject to strong demand-side discipline as well as stiff competition across the single market. Investors will need understandable and reliable disclosures which allow them to select competitive products offering the most attractive risk-return combinations. They will need to be able to count on the quality and objectivity of services provided by financial advisors and intermediaries who sell investment funds to them. On both counts, progress is needed.

## 2.1. Simplified Prospectus

The simplified Prospectus was intended to provide investors and intermediaries with basic information about the possible risks, associated charges, and expected outcomes of the respective product. However, it has manifestly failed. In most cases, the document is too long and not understood by its intended readers. It has been the victim of divergent implementation and 'gold-plating': the relevant Commission Recommendation<sup>10</sup> has been honoured more in the breach than in the practice. The result is a massive paper-chase of limited value to investors and a considerable overhead for the fund industry.

Despite these deficiencies, there is strong support for standardised off-the-shelf fund disclosures. Work is needed to re-centre the simplified Prospectus on delivering a short and understandable statement of charges, risks and expected performance which is meaningful to the end-investor. It should contain the same basic disclosures for all UCITS wherever they are domiciled in the EU. It will be necessary to change the provisions of the existing Directive so as to better specify its rationale and core principles; and to allow the adoption of implementing legislation to give uniform legally binding expression to those principles. This work could serve as a benchmark for effective off-the-shelf risk and cost disclosures for other investment products such as unit-linked life insurance.

The shortcomings of the Simplified Prospectus are too significant to await amendment of the Directive. Practical steps to correct the failings of the simplified Prospectus will be set in motion without delay. Recent workshops have identified the areas in which the simplified Prospectus needs improvement. The Commission will seek to codify enhanced risk, cost and performance disclosures through a revision of its Recommendation on this subject. This work will be taken forward on the basis of contributions from CESR and national authorities. Evolving work in this area will be tested with investors and intermediaries in order to ensure that it makes a useful contribution to investment selection. Proper consumer and market testing will take time. Nevertheless, it is hoped that non-legislative improvements can be brought forward by mid-2008. These improvements will be given a legally binding status following the entry into force of Directive amendments.

A two-level approach is required. The Directive itself must be amended to clarify the fundamental objectives and guiding principles of the simplified Prospectus. And also to allow for the adoption of legally binding implementing measures to give effective and uniform expression to those principles. Prior to entry into force of the amended Directive, the Commission will revisit its Recommendation to enhance risk, cost and performance disclosures. This work will be undertaken in close association with Member States, and be carefully tested with investors, distributors and industry.

## 2.2. Distribution systems: putting investor interests first:

Distribution systems which match investor demand with fund supply must work efficiently. They must deliver products that meet the needs of individual investors on competitive terms. At present, fund distribution accounts for the biggest single

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<sup>10</sup> 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

component of costs in the investment fund industry – ranging from 46% of total costs in France to 75% in Italy.

The move from foreclosed distribution systems towards open or guided architecture - where intermediaries offer a range of third party products - is gathering pace. This change can be to the great advantage of the investor if third party funds are selected on the basis of objective considerations such as cost or expected performance. Considerations, such as the level of commissions paid by fund promoters to distributors, should not bias the selection of funds. 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 must diligently undertake duties of care to the retail client. MiFID provides the tools to manage these concerns. Its implementing measures stipulate that inducements must be disclosed and can only be provided where they are in the interests of the client.

More generally, MiFID should underpin the quality of client support that advisors, brokers and other intermediaries provide to clients contemplating investment in investment funds. It will increase the onus on investment firms that sell funds to ensure that the product is appropriate for the individual client, and that the client is fully apprised of any risk warnings related to particular products.

The Commission will carefully monitor the implementation of MiFID rules on "conduct of business" and inducements in respect of intermediated fund sales. The Commission services will publish a 'vade-mecum' to consolidate the effective implementation of these provisions in order to ensure that investors can count on objective and professional fund intermediation.

### **3. SINGLE MARKET SOLUTIONS FOR NON-HARMONISED RETAIL FUNDS?**

The UCITS framework no longer covers the range of investment funds that can be marketed to retail investors under fragmented national regimes. There are categories of investment fund which are not UCITS compatible because of aspects of their investment policy or fund structuring. They may nevertheless be widely available to retail investors at national level – subject to differing forms of product or distribution regulation. The absence of a passport is a source of frustration for long-established retail products such as open-ended real estate funds (150 billion€ in assets under management [AuM] in EU) which see potential benefit in serving a pan-European investor base. There is broadening investor exposure, subject to varying conditions or restrictions and via different distribution methods, to non-harmonised funds.

The Commission estimates that assets under management by the retail-oriented non-harmonised industry amount to approximately 10% of total assets under management. This segment of the investment fund industry has no formal framework to support cross-border retail sales. Should one be put in place? Before responding affirmatively to this question, there is a need for greater clarity on the following issues:

- (1) Are the risk and performance characteristics of the funds in question such that they are broadly suitable for sale to the retail investor on an unadvised basis?

- (2) Will the provision of passporting mechanism deliver real and material benefits for the sectors concerned, investors and the wider marketplace taking account of the additional regulatory costs and other implications of putting such a mechanism in place? These reflections should also establish that a single market framework is realistic and practical having regard to the variety of trading strategies, asset classes, financial engineering and widely varying investment cultures across the Member States.
- (3) If a single market enabling framework is needed, how can it be realised most effectively?
  - (a) One possible legislative route is to enlarge further the scope of the current UCITS framework. However, UCITS provisions on fund structuring and investment policy might have to be extensively reshaped along more principle-based lines to accommodate further classes of non-harmonised fund. Such changes cannot be undertaken without carefully assessing the risk of diluting core investor safeguards and possible impact for the wider UCITS market. Would the re-scoping and reshaping of the UCITS Directive, that would be necessary to accommodate further classes of non-harmonised funds, deliver substantial net benefits and at the same time sustain high levels of investor protection?
  - (b) Would it be possible to introduce product-specific regimes alongside the UCITS Directive? This risks creating a regulatory landscape which is fragmented on a product by-product basis, leading to market distortions and regulatory arbitrage. It also runs the risk of entailing perpetual adjustment to the legal framework as new investment policies emerge.

Given uncertainty on the likely impacts or best way forward, the Commission does not believe that the time is ripe to table legislative initiatives to integrate markets for some non-harmonised funds at this stage. However it will undertake a systematic analysis of these issues, including consultations with practitioners and experts in the relevant areas, giving priority to real estate funds, in respect of which it will establish an expert group, as the basis for a sound and empirically based decision in 2008.

The Commission will study the likely costs, benefits and risks of providing an enabling single market framework for non-harmonised retail products and whether such products are suitable in the first place for marketing to investors on a cross border basis. Where extensive research and input from industry, investors and regulators makes a persuasive case for developing single market solutions for some non-harmonised products, the Commission will consider the options available and the nature of any changes to the UCITS framework that would be required. The Commission will report to Council and Parliament on the conclusions of this assessment in 2008.

#### **4. MARKETING AND SALE OF PRODUCTS TO "QUALIFIED INVESTORS":**

There are also non-UCITS funds which have generally been regarded as more suitable for institutional and other sophisticated investors who are capable of self-directed investment decisions. Examples include private equity funds and much hedge fund

investing. These are typically investment products where there is a relatively high probability of very adverse investment outcomes. They may also be products embodying new forms of risk (for instance, difficulties in asset valuation).

There is no common European approach to distinguish products which are suitable for the retail public from products which should remain the preserve of sophisticated investors. National experience has shown that there is no fully satisfactory basis for making a cast-iron distinction. View as to what is a safe product for retail investment change over time, as new asset classes mature, risk features are better understood.

MiFID replaces crude restrictions on the sale of certain instruments to certain categories of investor with a system which places responsibility on the investment firm to ascertain, on a client-by-client, basis whether a particular investment is suitable or appropriate. For many Member States, this will represent a new approach to investor protection. Enforcement authorities will have to invest heavily in order to ensure that investment firms understand what is expected of them. The implementation of this approach will be carefully monitored in order to ensure that investment firms across Europe rigorously implement these controls. The Commission services, working closely with national authorities, will examine the types of marketing and sales restrictions that should be removed in the context of the shift to conduct of business rules at the level of the investment firm. In this process, particular attention will be paid to the marketing and sale of non-harmonised funds, which entail relatively high probability of very adverse investment outcomes.

Alongside this process, the Commission will establish an inventory of national rules and restrictions which impede the 'private offer' of funds and other financial instruments to institutional investors and other eligible counterparties. There are no compelling investor protection reasons for national regulators to interfere in financial transactions involving professional investors who understand the risks associated with an investment. The Commission will work to free up cross-border transactions between designated counterparties, as long as they remain within the perimeters of a common '**private placement**' regime. MiFID and the Prospectus Directive put in place some of the key building-blocks of such a regime – by providing for the non-applicability of conduct of business rules and selling restrictions to certain transactions. It will be necessary to complete the picture by dealing with residual obstacles originating from national rules on product approval. The Commission believes that such arrangements can make an important contribution to the deepening of European markets for institutional products such as private equity investments. Based on a systematic analysis of these rules, involving CESR and the newly created European Securities Markets Expert Group (ESME), the Commission will report to the Council and Parliament on the most effective means to establish a common approach to private placement in autumn 2007.

The Commission services, working with CESR and national authorities will study the types of marketing and sales restrictions that should be repealed in favour of reliance on the investment firms exercising responsibility for the sale of products on a client-by-client basis.

As part of this process, the Commission and CESR will undertake a systematic inventory and analysis of national barriers to 'private placement' of financial instruments with institutional investors and other eligible counterparties. The Commission will report to

## **5. CONCLUSIONS:**

Investment funds are a well-established and important pillar of the European financial system. Their importance is set to grow as European investors use them as one means to provide for a prosperous retirement. A sound and efficient regulatory environment is a precondition for the continued successful development of European investment fund markets.

This White Paper has identified a package of measures designed to simplify the operating environment for investment funds – notably by overhauling cumbersome notification procedures and slimming down the simplified Prospectus. These steps will create new opportunities for cross-border operators without imposing significant additional costs for other industry participants. The White Paper also identifies the need to give investors better tools to make informed decisions, and to ensure that they receive objective and impartial assistance from fund distributors. This package of actions represents a carefully prepared agenda of immediate relevance to European fund industry and its investors.

The growing importance of this business means that there will be a need for continued attention to modernisation and development of the EU legislative framework. The envisaged amendments to the UCITS Directive may not be the final word. Recent innovation in investment techniques and products means that EU and national authorities will continue to face hard questions about the scope and design of the European legislative framework for investment funds. Rather than leap to hasty conclusions, this White Paper proposes to examine these issues more carefully, in order to allow a more informed policy debate as these new products and asset classes mature.

– **Annex 1: List of actions pursuant to the White Paper:**

**A. Proposal to modify Directive 85/611:**

The Commission will propose targeted adjustments and additions to: 1). simplify existing passporting mechanisms and expand the freedoms available to UCITS funds and their managers; 2). underpin an effective and relevant simplified Prospectus; 3). enhance supervisory cooperation. Proposals for legislative amendments will be tabled as a single package in autumn 2007. As part of its commitment to transparency, the Commission services will undertake open consultation on envisaged proposals in spring 2007. This consultation will also provide for scrutiny of the envisaged measure from a cost-effectiveness perspective. Amended or new provisions of the Directive will provide for the use of detailed implementing legislation to define the manner in which the rights or obligations should be exercised. This will allow for greater legal certainty and uniformity in the implementation of rights and obligations flowing from the Directive and more flexible adaptation to changing market circumstance and investor needs. Expected timing: The Commission will publish its proposal in autumn 2007.

**B. Non-legislative actions to support improvements in the UCITS framework:**

- Communication, recalling relevant ECJ case-law, to clarify that national capital gains tax treatment of mergers of locally domiciled funds should be extended to mergers involving funds from another Member State. Expected timing: early 2008
- Revision of Commission Recommendation on Simplified Prospectus, based on guidance from CESR and consultation and consumer testing. This work will be undertaken in parallel to modification of the relevant provisions of the Directive. Expected timing for launch of the work: early 2007: target completion date, mid-2008.
- Vade-mecum of Commission services on application on relevant provisions of MiFID to collective investments/UCITS. Expected timing: summer 2007.
- Communication/Recommendation on delegation of custodial functions by depositaries and designation of EU bank branches as depositary: expected timing: early 2008.

**C. Non-harmonised investment funds:**

- Review of national rules governing placement of financial instruments including certain funds with qualified investors and first assessment of options for building a common European private placement regime: Expected timing: autumn 2007.
- New research on investment policies for harmonised and non-harmonised funds, and related risk and performance: publication of results – end 2007;
- Creation of an expert group on open-ended real estate funds: publication of report – autumn 2007;
- Report of Commission to Council and Parliament assessing the need for and possible options for developing the single market framework for certain retail-oriented non-harmonised funds: mid-2008.