CFA INSTITUTE | Centre for Financial Market Integrity

The Committee of European Securities Regulators
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21st August 2008

Call for evidence on the request for advice to CESR on the UCITS asset management company passport

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to participate in the "Call for evidence on the request for advice to CESR on the Undertakings for Collective Investment in Transferable Securities ("UCITS") asset management company passport" (the "Consultation").

The CFA Institute Centre[1] promotes fair and open global capital markets and advocates for investors' protection. Accordingly, we attach great importance to the UCITS Directive, which establishes the common framework for laws, regulations, and administrative provisions relating to retail investment funds in the European Union.

The Consultation forms part of the European Commission's efforts to revise the UCITS Directive through a package of legislative amendments. Specifically, the Consultation addresses the regulatory and supervisory issues that would arise in the event that a Management Company Passport (the "Passport") is incorporated into the UCITS Directive. This Passport would enable a fund management company to be domiciled in a different Member State from the UCITS fund's home Member State.

Currently, whilst the UCITS fund (the "Fund") can be marketed and sold in any EU Member State, the Fund cannot be domiciled in a given Member State without the formal registration of the management company and depositary in that same Member State. Under this arrangement, each entity is accountable to a single enforcement authority, being the local regulatory body (or "competent authority"). Therefore, the primary consideration of the Passport is whether its introduction would result in the same levels of investor protection afforded under the current supervisory framework.

Broadly, the CFA Institute Centre supports the introduction of the Passport into the UCITS Directive. In our view, the requirement to domicile each entity involved in the management and administration of the Fund in the same Member State disproportionately bears on costs relative to the levels of investor protection. Provided appropriate mechanisms are put in place to allocate supervisory responsibilities and to share

[1] The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

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information amongst competent authorities, we see no adverse implications for investor protection from introducing the Passport. This position is based upon the expectation that all Member States will interpret, implement, and enforce the UCITS Directive in a reasonably similar manner, as is envisioned in the Financial Services Action Plan.

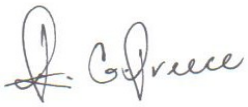
Moreover, the existing framework presents an impediment to the efficient functioning of the funds industry, by requiring a higher level of capital charges than need be the case. If firms were afforded the flexibility to domicile funds in any Member State without the restriction of also having to establish the management company and depositary in that same Member State, cost savings could be achieved.

This also would result in a more efficient allocation of resources, as firms could base the different functions of the business (such as investment management, administration, safekeeping, marketing, etc) in the jurisdiction that offers the lowest cost and / or most talented labour pool. Ultimately, this should not detriment the existing levels of investor protection. The existing provisions of the UCITS Directive, when combined with formal structures such as colleges of supervisors, should be sufficiently strong to mitigate any perceived risks arising from the introduction of the Passport.

In the context of "formal structures" to underpin cooperation between competent authorities, we advocate the role of a central repository for the EU (a concept addressed in section 3.2 below). A central repository, acting as a central facility for the filing of regulatory information, would facilitate the exchange of information between competent authorities. By making information on the management company and Fund (potentially domiciled in different jurisdictions) immediately available to all authorities at the same time, the level of communication and cooperation amongst regulators would be enhanced. This is key to ensuring the effective cross-border supervision of the UCITS business.

We attach our response that addresses the requests for advice set out in the Consultation. Please do not hesitate to contact us should you wish to discuss any of the points raised.

Yours faithfully,



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The CFA Institute Centre is part of CFA Institute[2]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of approximately 95,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom more than 81,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 56 countries and territories.

Our detailed comments follow the order of the 'Content of Advice' set out in section 3 of the Consultation.

3.1 Definition of domicile.

"CESR is asked to advise on the elements that could be used to distinguish the home Member State of the management company, that of the UCITS fund and that of the depositary in situations where use is made of the management company passport. Particular consideration should be given to the case of UCITS funds established under contractual or trust law."

Definition of domicile is central to the goal of achieving a clear and systematic allocation of regulatory responsibilities between competent authorities responsible for the management company, depositary, and the Fund.

Under the present regulatory arrangements, the home Member State of the management company is determined to be the Member State where the management company has its registered office. This is an effective arrangement for the prudential supervision of management companies by local competent authorities, and the introduction of the Passport would not (and should not) affect this. It is possible that there could be some loss of supervisory responsibilities if, under the current arrangements, a fund manager has established a management company in more than one jurisdiction to allow a Fund to be domiciled in a given jurisdiction. However, having the management company regulated and supervised by the competent authority of the jurisdiction in which the management company is registered has no adverse implications for investor protection. It will however be necessary to put in place adequate mechanisms for the sharing of information amongst competent authorities, a subject that is addressed separately in this letter.

In order to determine the domicile of the Fund, consideration must first be given to the Fund structure. UCITS funds are typically either structured in the corporate form (such as Open-Ended Investment Companies (OEICs) / Investment Companies with Variable Capital (ICVCs)) or in the non-corporate form (such as unit trusts and common contractual funds). The former structure is most common, and exists as a distinct legal entity. Funds of the latter form, however, are not separate legal entities, being established under a contractual or trust deed by the management company. It follows that determining the domicile for a Fund established in the corporate form (hereon referred to as an "OEIC") is clearer than that for a Fund established in the non-corporate form.

[2] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

As with the management company, the most obvious criterion for distinguishing the home Member State of an OEIC would be the jurisdiction in which the OEIC is legally incorporated. However, this criterion would not be possible for UCITS funds under contractual or trust law since these funds are not recognised as stand-alone legal entities.

Therefore, the easiest, most cost-effective and practical solution for domiciling contractual funds and unit trusts is for these funds to be domiciled in the same jurisdiction as the management company. Given that these funds are established under a deed between the management company and depositary, and having regard to the responsibility of the management company for the day to day administration of the Fund, it would be most practical for the Fund to follow the management company in its domiciliation. This would be the most effective arrangement for regulatory supervision. An alternative measure would be to domicile the Fund in the same jurisdiction as the depositary, having regard to the depositary's responsibility for the safekeeping of the assets on behalf of the unitholders. However, in practice it is likely that domiciling the Fund with the management company would be more effective, given that the manager has greater direct involvement on a day to day basis with the Fund, and is responsible for maintaining the books and records.

Alternative approaches to domiciling contractual and trust funds may not be feasible, not only from a legal standpoint. Consider, for example, basing the domicile of the Fund on the jurisdiction in which the Fund makes the majority of its unit/share sales (hereon units and shares are collectively referred to as "shares"), or the jurisdiction in which the majority of shareholders reside based on the shareholders' register. Whilst having the benefit of being applicable to both corporate and non-corporate Form funds, such criteria would be impractical from a supervisory perspective as they could give rise to a dynamic ownership structure. Where two countries are very close in terms of ownership of the Fund's shares, changes in ownership and/or sales into each market could literally keep the country with the most sales and shareowners changing every quarter. This scenario highlights the practicality, or necessity, to domicile contractual and trust funds in the same jurisdiction as the management company.

A suitable basis for determining the home Member State of the depositary would be the jurisdiction in which the depositary is registered. Use of the Passport would enable the depositary to locate in a different Member State from the Fund. As in the case of the management company, domiciling the depositary in the Member State in which it has its registered office should not create additional risks to investor protection, provided there are adequate mechanisms for the sharing of information amongst competent authorities and the local competent authorities have interpreted, implemented, and enforce the UCITS Directive in a similar manner.

3.2 Applicable law and allocation of supervisory responsibilities.

"CESR is asked to review the current specification of provisions of UCITS law that are binding at the level of the management company and at the level of the fund and depositary, and advise on whether the envisaged allocation of responsibilities are

sufficiently complete and effective to cater for situations where the management company and UCITS fund are in different Member States.

In particular, CESR is asked to identify and propose solutions to any identified gaps in supervision or overlapping responsibilities that might arise if the management company and fund / depositary are located in different Member States.

CESR is asked to advise on whether formal structures (e.g colleges of supervisors or MoUs) are needed to underpin cooperation between competent authorities responsible for management company and the UCITS fund."

The current specifications of UCITS law regarding the obligations of management companies are set out in sections III and IV of the UCITS Directive[3]. Obligations regarding the depositary are set out in sections IIIa and IVa, while obligations concerning the constitution and functioning of the UCITS fund are set out in sections V to VIII. Section IX addresses the provisions concerning the authorities responsible for the authorisation and supervision of the Fund.

The existing provisions of the UCITS Directive cater for situations where a management company or Fund establishes a branch or markets shares in a Member State (referred to as the "host") that is different from the home Member State. Under these provisions, the home Member State must communicate information to the host Member State.

For example, in the case of the management company, Article 6a of section III sets out the information that must be provided by the competent authority of the home Member State to the host Member State in order for the host competent authority to monitor the activities of the 'branch' management company set-up in its jurisdiction. Article 6c(1) permits the competent authorities of host Member States to request the management company with a branch in its jurisdiction to report periodically on its activities in the host Member State. Article 6c(2) provides further clarification:

> *"Host Member States may require management companies, carrying on business within their territories … to provide the information necessary for the monitoring of their compliance with the standards set by the host Member State…"*

Therefore, whilst the competent authority of the home Member State is ultimately responsible for regulation and supervision of the management company, the existing specifications require the host Member State to be provided with information on the management company, and for the host Member State to have the powers to effectively monitor its activities in the host's jurisdiction. Furthermore, under Article 6c(6), host Member States are able to

> *"… take appropriate measures to prevent or to penalise irregularities committed within their territories which are contrary to legal or regulatory provisions adopted in the interest of the general good."*

[3] Council Directive 85/611/EEC of 20 December 1985, as amended. See: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1985L0611:20050413:EN:PDF

Similarly, in the case of the Fund, Article 46 of section VIII sets out the information that must be sent to the host competent authority when the Fund seeks to market its shares in a Member State that is not the Fund's home Member State. This information must be sent with a notification to the host competent authority that the Fund intends to market its shares in the host's jurisdiction.

Under Article 49(3) of section IX, the authorities of the Member State in which the Fund markets its shares *"shall be competent to supervise compliance …"* Furthermore, Article 50 states:

> *"The authorities of the Member States referred to in Article 49 shall collaborate closely in order to carry out their task and must for that purpose alone communicate to each other all information required."*

In our view, these measures (as exemplified for both the management company and Fund) are sufficiently robust to cater for the effective specific supervision and monitoring of the management company, depositary, and Fund, in the cases envisaged where their domicile differs. Accordingly, we do not consider that the existing provisions of UCITS law would be weakened by the introduction of the Management Company Passport.

To ensure that regulatory gaps do not arise, however, the framework could be strengthened through the creation of formal structures. Two examples cited in the Consultation are Colleges of Supervisors, and MoUs (Memorandums of Understanding). The purpose of any formal structure is to enhance cross-border supervision of entities that operate in several jurisdictions, through facilitating the exchange of information, and through improving coordination and understanding amongst national regulators.

One structure that CFA Institute Centre advocates, however, is a central repository for the EU, a concept we have addressed in earlier CESR consultations[4]. This repository would act as a central facility for the collection and dissemination of relevant information amongst national competent authorities, thus facilitating the exchange of information, and improving coordination amongst national regulators. In this capacity, it could exist alongside other structures that CESR proposes for cross-border supervision (such as Colleges of Supervisors), and is therefore envisaged as a complementary mechanism to improve supervision. Specifically, the national competent authorities would file all relevant information with the central repository. Such information, as required under the UCITS Directive, would include (but would not be limited to) the registered office of the management company and depositary, the names of those responsible for the management company and depositary, a programme of operations setting out the activities and services of the different functions (such as investment management, administration, marketing), the Fund's trust deed / instrument of incorporation, the latest annual report of the Fund, the key information document, etc. Competent authorities from the relevant Member States, as well as investors, could then access this

[4] See, for example, our comment letters on market abuse submitted to CESR in 2002, 2004, and 2008, at http://www.cfainstitute.org/centre/topics/comment/2002/pdf/02market_abuse.pdf; http://www.cfainstitute.org/centre/topics/comment/2004/CESRcommentletter.html; and http://www.cfainstitute.org/centre/topics/comment/2008/080814.html

information from the central repository as required. The benefits of such a system (set out in our January 2004 comment letter to CESR[4]) include:

- It would eliminate the need for complicated implementing measures directing cooperation and communication among competent authorities that may not accurately consider market evolution.
- Regulators in all markets would likely create algorithms to automatically download information from the repository about investment firms and funds headquartered and/or registered in their home markets, thereby enhancing the efficiency of the regulatory system.
- It would make the information immediately available to all authorities at the same time, thus raising the level of communication and cooperation amongst regulators.
- Investors across the European Union would have one place to obtain vital Fund information instead of having to visit website addresses and know the languages used by authorities in all Member States.
- Authorities would not have to make judgments about when to share information and which of their counterparts should receive it.

3.3 Authorisation procedure for UCITS fund whose management company is established in another Member State.

"CESR is requested to advise on the need for and design of mechanism or process which will allow for checking that qualifications of the management company (authorised in another Member State) are commensurate with the demands/risks embedded in the investment policy of the UCITS fund.

CESR is asked to advise on any duly motivated circumstances under which a management company could be refused permission to manage/set up a fund in another Member State."

A key consideration for investor protection is the risk management framework surrounding the operation of the Fund. Under Article 5f of the UCITS Directive, the competent authority, having regard to the nature of the Fund, shall require the management company to have

> *"…sound administrative and accounting procedures, control and safeguard arrangements for the electronic data processing and adequate internal control mechanisms…"*.

Article 24a(4) goes further to state that:

> *"Upon request of an investor, the management company must also provide supplementary information relating to the quantitative limits that apply in the risk management of the UCITS, to the methods chosen to this end and to the recent evolution of the main instrument categories' risks and yields"*

These requirements ensure that the management company has proper risk management systems in place to manage the risk profile embedded in the Fund. Domiciling the Fund in

a different jurisdiction from the management company, as envisaged under the Passport, should not impair these requirements.

The focus of the request for advice, therefore, should be on the process for *"checking [that] the qualifications of the management company are commensurate"* with the risks of the Fund. To this end, the competent authority in the home Member State of the management company should be responsible for ascertaining that the management company has appropriate systems, procedures, and controls in place to effectively manage the risks of the Fund. In order for this to be permissible under the Passport, information on the risk profile of the Fund must be easy accessible and publicly available. The concept of a central repository, as detailed in section 3.2 above, would be an appropriate mechanism through which the competent authority (in the home Member State of the management company) could access the necessary information on the Fund. This would enable the home competent authority to verify that the management company has the appropriate "qualifications" to manage the risk profile of the Fund, regardless of the home jurisdiction of the Fund.

Moreover, provided that the home competent authority of the management company has the *means necessary* (such as through a central repository) to *verify* that the management company has the appropriate systems, procedures, and controls, we do not envisage circumstances where that management company would be refused permission to set-up a Fund in a different Member State. Only where the relevant competent authority determines that the qualifications of the management company are not commensurate with the demands of the Fund would permission be refused.

3.4 On-going supervision of the management of the fund.

"CESR is asked to advise on the conditions (e.g in terms of direct or indirect access to or control of certain functions or process) needed to ensure that the supervisor of the UCITS and the supervisor of its management company have sufficient means and information to discharge their duties effectively.

CESR is asked to advise on the obligations of information and conduct of business that the management company owes to the UCITS fund and depositary (and vice versa).

CESR is asked to advise on the mechanisms or procedures that should be envisaged to ensure the timely and effective exchange of information between a UCITS supervisor and a supervisor of a management company (or vice versa)."

The request for advice in this section focuses on the exchange of information, which is central to the on-going supervision of the management of the Fund amongst competent authorities. Cross-border cooperation and supervision is dependent upon effective mechanisms to facilitate the sharing of information. To this end, we advocate the role of a central repository. Please refer to our response to section 3.2.

3.5 Dealing with breaches of rules governing the management of the fund.

"CESR is asked to advise on any mechanisms or information flows that are needed to ensure that the respective competent authorities are duly and quickly informed of any breach of the rules governing the management of the fund; and the conditions under which effective enforcement action can be undertaken.

CESR is invited to advise on the need for and form of any additional measures to facilitate effective enforcement action by authorities responsible for a contractual form UCITS fund when the management company is established in another Member State."

Presently, management companies are required to report breaches of any rules governing the management of the Fund to the home competent authority. To ensure that the respective competent authorities in the different jurisdictions are timely informed of any breaches, as would be necessary under the Passport, the competent authorities could file breach reports with a central repository. As we detail in section 3.2, this would have the benefit of making breach information immediately available to all authorities at the same time. Furthermore, competent authorities would not have to make judgments about when to share information and which of their counterparts should receive it. A central repository would thus be an effective mechanism for ensuring that competent authorities are duly and quickly informed of all breaches.

With regards to enforcement, the relevant home competent authority, on receipt of the breach report, would act to ensure that actions are taken to remedy the breach. Such enforcement action is easy to take against the management company, depositary, and Fund, where that Fund is structured in the corporate form (e.g as an OEIC). However, as the Consultation notes, this situation is less clear for contractual funds which have no distinct legal entity. Specifically, enforcement action may be difficult if the contractual fund is domiciled in a Member State that differs from the home Member State of the management company.

This argument relates back to section 3.1, which addresses the issue of domicile. Specifically, it reinforces the view that it is necessary to domicile a contractual or trust fund in the same jurisdiction as the management company. As these funds have no legal identity, it would only be possible to take enforcement action against the management company or depositary, being the relevant legal entities that established the funds. Therefore, to avoid gaps in regulatory enforcement, contractual and trust funds should be domiciled with the management company. We do not see any practical alternatives to this arrangement (for the reasons set out in our comments under section 3.1).

To conclude, it is necessary to establish firm, clear criteria that determine the domicile of the Fund. This is addressed in section 3.1. Secondly, it should be ensured that the UCITS Directive is drafted to permit the competent authorities in the jurisdiction in which the Fund is domiciled, based on the afore-mentioned criteria, to direct enforcement action as necessary. This of course would be facilitated through cooperation with the competent authority of the management company, via the formal structures – such as a central repository – advocated herein.

21st August 2008.