European Commission

ROADMAP			
TITLE OF THE INITIATIVE	Reforming the framework for collective investment funds/UCITS VI (focus on log-term investments, product rules and depositaries)		
LEAD DG – RESPONSIBLE UNIT	DG MARKT – Asset Management unit (G4)	**DATE OF ROADMAP**	10 / 2012
This indicative roadmap is provided for information purposes only and is subject to change. It does not prejudge the final decision of the Commission on whether this initiative will be pursued or on its final content and structure.			

A. Context and problem definition

(1) What is the political context of the initiative?
(2) How does it relate to past and possible future initiatives, and to other EU policies?

(1) What is the political context of the initiative?

The Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) establishes the regulatory framework governing retail investment funds that may be sold to professional and private investors across Europe. This framework is subject to regular amendments, most recently by means of a proposal in July 2012[1]. The latter aims at improving EU level harmonisation applicable to fund depositaries, promoting remuneration that is consistent with sound risk management and ensuring that a sanctioning regime for UCITS is effective and dissuasive.

Recent international work on shadow banking (post G20) established five work streams within the Financial Stability Board (FSB). Three of these have a direct link with investment funds: money market funds, efficient portfolio management techniques (e.g., securities lending and repurchase arrangements), and the one on other entities with their use of certain derivatives (e.g., the use of total return swaps by the investment fund industry). The Commission will closely monitor whether recommendations that will be issued by the FSB in the future will require corresponding updates to the UCITS rules.

Long-term investments (LTI) have attracted political attention as the short term investment horizons may not always allow for an appropriate financing of the European economy. Focus on long-term investments forms part of the Commission's efforts to promoting growth and the creation of new jobs in Europe. In this regard, the Single Market Act II (key action 6) and its stated aim to boost growth and strengthen confidence are relevant. A focus on long-term and sustainable investment is also linked to the Europe 2020 growth strategy. Long-term investors pursue the same objectives as Europe 2020: employment, innovation, education, social inclusion and climate change/energy policy.

More generally the intention is to address a number of concerns relating to the efficiency, competitiveness and integration of the market for UCITS based investment funds. UCITS has attracted funds not only from Europe but also from several other geographic regions outside Europe such as Asia. The political intention is to protect the UCITS 'brand' in order to preserve its attractiveness for both professional and retail investors.

(2) How does it relate to past and possible future initiatives, and to other EU policies?

The **green paper on shadow banking**[2] launched previously this year by the Commission was the occasion to gather first views on a number of subjects. This proposed initiative builds on and deepens the debate launched in the Green Paper on shadow banking.
A **green paper on long-term investments** from the Commission is foreseen by the end of the year. It will touch upon all topics related to long-term investments, not only on issues related to asset management.

The **European Market Infrastructure Regulation (EMIR)**[3] will introduce new rules regarding the central clearing of OTC derivatives. This means also that the central counterparty will be tasked with providing compensation between OTC counterparties (margin requirements). In light of these developments, the counterparty risk provisions in UCITS need to be re-evaluated.

What are the main problems which this initiative will address?

Work has been organized into four areas:

<u>Money Market Funds</u>

International working groups consider that MMFs are systemically relevant. Examples are cited to demonstrate the vulnerability of MMFs to large withdrawals from investors ("investor runs"). Their inability to face redemption requests can lead to disruptions in the short term funding market. Because MMFs are an important source of funding for the European economy, a lack of liquidity in the MMF sector may have detrimental effects on the whole economy. The perceived liquidity of MMFs may also be influenced by the method used to calculate the Net Asset Value (NAV) of a fund. Finally, so-called 'mechanistic' reliance on credit ratings in assessing a MMF's investment instruments is another area of concern since a downgrade of assets may provoke large sell-offs. The same applies when the MMF itself is rated and is subsequently downgraded.

International work produced several statistics highlighting differences between Europe and the US in terms of the importance of the MMF sector. The MMF sector in the US exceeds the European MMF more than twofold and also seems to play a larger role in financing governments and corporates. Nevertheless, as bank financing declines in Europe, it may be a good opportunity to ask whether the MMF can increase their role in financing the European economy.

Long-term investments

The short-termism of the financial markets is often not in line with the financing needs of the "real economy", small and medium sized but also larger companies that produce goods and services that generate growth, jobs and innovation. The financing of infrastructure projects, social entrepreneurships or start-up companies require investments with a long-term perspective. There is currently no specific EU framework in place that is tailored to longer term investments. National rules exist in some countries but the situation is far from optimal in terms of developing a deep and well-sourced capital pool for long term projects. In particular, UCITS rules are not adapted to long-term investments as LTI are often associated with lower level of liquidity. Long term investments cannot promise almost daily redemption. This situation reduces the opportunities to create a long term investment culture which also appeals to retail investors. Over a longer term horizon, the absence of such a framework can pose an impediment to European growth.

UCITS depositary

UCITS depositaries play a central role in administrating and overseeing funds domiciled in Europe. Current UCITS rules require that a fund's depositary is located in the same jurisdiction as the fund itself. This requirement, hitherto justified with considerations related to regulatory oversight, may lead to inefficiencies in the depositary sector. The introduction of more flexible rules on the domicile of a depositary could lead to more competition and lower fees in this area.

UCITS product rules

EPM techniques (securities lending and repurchase agreement) have been identified, within the international work on shadow banking, as relevant factors that contribute toward potential financial instability because EPM may increase the interconnectedness of various financial actors. Equally, the collateral exchanged between the EPM or OTC derivative counterparties needs to be of sufficient quality and provide adequate liquidity to meet redemption requests. Collateral is essential in avoiding systemic repercussions in case a counterparty faces bankruptcy.

UCITS rules establish eligibility criteria for the assets in which the managers can invest. Some of the UCTIS investment strategies and the assets that are implicated in these strategies may be of systemic importance, e.g., total return swaps. In light of recent developments at FSB level, these strategies need to be assessed.

The current UCITS framework does not contain any liquidity rules that should apply in stressed market conditions. This may lead to different practices among Member States – a fact that can have detrimental consequences for the stability of the financial system. Different practices may also be an impediment to the integration of the fund industry in Europe.

Who will be affected by it?

The fund managers, the depositaries, the supervisors in Member States, the investors, the investment targets of the UCITS.

Is EU action justified on grounds of subsidiarity? Why can Member States not achieve the objectives of the proposed action sufficiently by themselves? Can the EU achieve the objectives better?

The G20 Summits agreed on close monitoring of all activities outside the traditional banking system. The FSB is coordinating international efforts in this respect. This provides a clear indication that policies with respect to shadow banking require coordinated actions at international level. The Commission's Green Paper underlines the cross-border dimension of shadow banking and its repercussions on financial stability.

As the above mentioned topics are intrinsically linked to the current framework governing investment funds, UCITS, action at EU level appears most suitable to integrate international developments into European legislation.

B. Objectives of the initiative

What are the main policy objectives?

Given the overall effect of the problems identified, the **general objectives** of this analysis are (i) to create a regulatory framework that provides for robust investor protection, (ii) to further strengthen the EU internal market efficiency in the investment fund sector, and (iii) to enhance the role of European investment funds in financing the European economy.

At **operational level**, the aim of the changes being considered within the UCITS framework aim at providing appropriate solutions in each of the above areas:

i. Money market funds: prevent contagion effects, increase liquidity safeguards, reduce reliance on ratings, facilitate financing of corporates and governments through MMFs

ii. Long-term investments: foster financing of the real economy, create a single market for long-term funds with retail access, promote investments in social projects, promote a long-term investment culture by managers

iii. Depositary passport: facilitate cross border depositary services, increase competition in the provision of depositary services, reduce costs of depositary services for funds and thus for investors.

iv. UCITS product rules: reduce complexity of certain UCITS investment strategies and increase investor protection by introducing uniform rules governing securities lending, repos and reverse repos, introducing uniform rules mitigating counterparty risk and clarifying the approach to complex derivatives-based strategies employed by UCITS funds. In relation to liquidity management: prevent liquidity bottlenecks and ensure uniform application of liquidity management throughout the EU.

Do the objectives imply developing EU policy in new areas?

It is likely that reforming all mentioned areas will require not only amending the UCITS framework but also creating new regulations. Money Market Funds, long-term investments and depositary passport may all require separate and independent legislation.

C. Options

(1) What legislative or 'soft law' instruments could be considered?

(2) What are the policy options (including exemptions/adapted regimes e.g. for SMEs) being considered?

(1) What legislative or 'soft law' instruments could be considered?

Policy instruments, such as recommendation or communication are not considered as having sufficient effect given that the identified issues are closely linked to the existing regulatory framework. The stated aim of a uniform EU approach to the above-mentioned issues can only be achieved if this framework itself is modified. Soft law instruments cannot achieve this effect.

(2) What are the policy options (including exemptions/adapted regimes e.g. for SMEs) being considered?

Money Market Funds

To reduce their susceptibility to investor's runs, the options could consist in either mandating the use of a variable NAV calculation reflecting the market value of MMF assets or the introduction of capital buffers. Liquidity levels could be increased through the introduction of various mechanisms such as liquidity fees, redemption restrictions or liquidity constraints. The mechanistic reliance on credit ratings could be balanced with an internal assessment process made by the manager. Overall, options to increase the role MMFs play in financing governments and corporates will be explored, such as introducing specific rules for this type of asset class or creating a specific MMF label. As not all MMF fall within the perimeter of the UCITS Directive, these policy changes may require recourse to a stand-alone regulation that exists alongside the UCITS framework.

Long-term investments

To create a European market for LTI, two solutions could be explored: adapting the UCITS framework or creating a new stand-alone regulation for LTI.
As social investments, as a sub-group within LTI, may require special attention, options envisaged could either be to integrate social investments into UCITS or into a new stand-alone instrument.
Other ways to promote a culture of long term investing, such as issuing high level recommendations, prescribing more involvement in the corporate governance by managers, creating long term investment labels, might accompany any regulatory effort in this area.

Depositary passport

Different forms of a passport with various levels of accompanying harmonisation will be assessed. The introduction of a passport, in order to avoid regulatory arbitrage, may need to be accompanied by the appropriate supervisory framework for depositary activities.

UCITS product rules

On EPM techniques, options range from an increase in transparency to more precise rules on the contours of permissible EPM techniques. Specific options concerning the collateral posted in the context of EPM transactions and derivative contracts, such as diversification, eligibility, haircuts, etc. will be analysed. Regarding eligible assets and liquidity management, different tools for managing liquidity (evaluation of assets, gates, redemption fees, etc.) will be assessed.

(3) How do the options respect the proportionality principle?

All foreseen options will reflect a cost-benefit analysis. The Commission approach builds on the extensive consultations and input gathered from a wide range of stakeholders. The choice of the preferred policy options shall proportionately reflect the retail nature of the UCITS product, setting it duly apart from the similar AIFM framework where necessary.

D. Initial assessment of impacts

What are the benefits and costs of each of the policy options?

It is premature at this stage to give precise benefits and costs for each foreseen option. Here below is just a summary of the preliminary expected impacts. A consultation launched in July on all these topics will help us to analyse benefits and costs.[4]

Money Market Funds

i. Changing valuation methods for a MMF' is one possible tool to decrease the incentives for the investors to redeem early, thus avoiding investor's runs. On the other hand, any changes in fund valuation may prove disruptive for certain funds. Capital buffers could be difficult to establish in a short time frame and expensive for investors or fund sponsors to introduce. It is also uncertain whether capital buffers will be able to cover all potential losses.

ii. Another tool to manage the risk of investor runs while preserving MMF as a cash management tool is redemption fees or restrictions on redemptions. These tools could diminish advantages for investors who move first in a redemption cycle. Applying higher standards on asset maturities could also increase the liquidity level of the funds.

iii. The right balance between managerial self-assessment of the MMF's investments and recourse to credit rating has to be established. Undue reliance on credit ratings should be avoided. On the other hand, giving flexibility to the manager to disregard or overrule credit ratings could be risky as it may incentivize managers to invest in lower quality assets. On the other side a 'mechanistic' reliance on ratings may be inappropriate as downgrades may provoke massive sell-offs and places too much emphasis on credit rating agencies.

Long-term investments

i. The UCITS framework is not always tailored to foster the development of LTI due to a number of reasons: high liquidity requirements, eligibility strongly biased to favour listed and transferable securities - not all LTI instruments are necessarily transferable securities.

ii. For this reason, a stand-alone regulation could represent a more viable option. This could permit the creation of an European fundraising passport for those that specialise in long-term instruments.

iii. LTI are often associated with long lock-up periods, higher risk and lower liquidity, therefore specific measures could be envisaged to keep an adequate standard of investor protection. Specific additional rules could allow retail investors to safely invest in this kind of investments.

iv. Allowing UCITS funds to invest in social funds (EuSEF) could bring considerable flow of capital in social businesses but could also at the same time reduce the liquidity level of the UCITS.

Depositary passport

i. Freeing up the rules on domiciliation of a depositary would increase the integration of the European market, enhance competition in the area of depositary services and reduce the fund's depositary fees.

ii. On the other hand, countries which are currently important fund domiciles may see the depositaries (with attached jobs and tax revenues) leaving their jurisdictions to relocate elsewhere in the EU. This relocation effect would, however, be limited as long as the depositary would be obliged to have its domicile within the EU.

iii. Regulatory arbitrage between Member States to attract the depositaries by applying lower supervisory standards is one major risk associated with free choice as to the domicile of a depositary. This, in consequence, may entail risks for the adequate supervision of investment funds. This risk may be mitigated by appropriate supervisory tools.

UCITS product rules

i. Different options to address EPM techniques could reduce possible systemic impacts these techniques may have on interconnected financial actors and transactions. On the other hand, stricter rules on EPM techniques may reduce the revenues that the funds collect from this activity which, in turn, may lower the return for investors.

ii. Imposing stricter rules could reduce the vulnerability of the financial system when a default occurs on some financial actors. On the other hand, it may be more expensive to post collateral if the required quality is higher.

iii. Introducing stricter criteria for assets eligible for a UCITS fund could increase confidence in the 'brand'. On the other hand, a reduction in eligible assets would decrease the investment strategies available for UCITS and potentially returns for investors.

iv. Special liquidity management rules could bring clarity in a field where the Member States apply different standards on redemptions and gates. Harmonisation would increase investor confidence and anticipate and potentially prevent systemic repercussions when a UCITS fund faces a liquidity crisis.

Could any or all of the options have significant impacts on (i) simplification, (ii) administrative burden and (iii) on relations with other countries, (iv) implementation arrangements? And (v) could any be difficult to transpose for certain Member States?

Since the overall focus of the changes to the UCITS legislative framework is to increase harmonisation in a number of areas where problems have been identified, it is expected that profits will emerge from the clarification of the key UCITS rules. As the patchwork of national requirements will be minimised, market participants will gain from enhanced legal certainty. However, it is also expected that new requirements will signify additional compliance costs. Where additional administrative burden will result from the initiative, it shall duly be put into the perspective of ensuring financial stability and improving investor protection. In the short term, market participants will rather likely have to bear higher compliance costs related to the necessary adjustments to their organisations.

No significant impacts are foreseen in relations with third countries. Regarding shadow banking areas, relevant third countries are committed to implement similar rules in accordance with the G20 commitments mentioned above and principles developed on their basis by Financial Stability Board (FSB).

(1) Will an IA be carried out for this initiative and/or possible follow-up initiatives?
(2) When will the IA work start?
(3) When will you set up the IA Steering Group and how often will it meet?
(4) What DGs will be invited?

IA work started in summer 2012. Directorates general and services that are involved in the IA include Competition, Health and Consumers, Taxation and Customs Union, Enterprise and Industry, Trade, Secretariat General, Economic and Financial Affairs, Legal Service. Once the IA is completed and approved by the Board, a series of initiatives will be proposed in the course of 2013. The precise sequence of these initiatives is still being reviewed.

Is any option likely to have impacts on the EU budget above € 5m?

It is foreseen that the options will have no impact on the EU budget. (may however depend on the conferral of new supervisory tasks to ESMA on depositaries)

E. Evidence base, planning of further work and consultation

What information and data are already available? Will existing IA and evaluation work be used?

To address these issues comprehensively, the Commission, in July 2012, launched a wide-ranging consultation. Contributions are sought from investors, fund managers, the depositary industry, other financial institutions and public authorities, in particular. The objective of the consultation paper is to gather evidence and experienced opinions with respect to the identified problems. We put the emphasis of the consultation on gathering the most possible amount of empirical data in order to support our assessment of the possible options.

Other sources will include data already gathered by international bodies such as the FSB, IOSCO and ESRB. Responses from precedent consultations will also play a major role such as the green paper on shadow banking.

More generally, data will be gathered through academic papers, studies conducted by trade organisations and research papers conducted by consultancy firms.

[1] http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm
[2] http://ec.europa.eu/internal_market/bank/shadow_banking/index_en.htm
[3] http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm
[4] http://ec.europa.eu/internal_market/consultations/docs/2012/ucits/ucits_consultation_en.pdf