

6 June 2006

Development of UCITS in the EU

How to foster the development of the retail investment funds market in Europe ?

Executive summary:

The European investment funds market has strongly increased over the recent years (a nearly four-fold increase in assets managed since 1994) and is progressively catching up in size with the US market.

However, the EU investment funds industry remains highly fragmented at all stages of the value chain (production / asset management, distribution, order processing and settlement). This hinders the capacity for industry players to market their products across Europe, develop further synergies and leverage potential economies of scale. This also means that full economic efficiency of the EU market is not exploited to the benefit of investors at present.

Further integration is needed to ensure the long term competitiveness of the EU funds market and its attractiveness for investors. Integration is also necessary for the further development of open-architecture concepts that should give investors access to “best-of-breed” products and enable to further increase competition.

The present proposals made by the European Commission in the UCITS Green Paper - development of funds passport, management company passport, cross-border funds mergers, pooling techniques (eg virtual pooling, master-feeder), depositary passport; further cross-border development of non-UCITS markets (hedge funds, private equity funds, real estate funds...) – are often recognised by the industry as significant progress drivers. The 2 expert groups set up by the Commission will further specify the necessary improvement actions and their implementation conditions.

These proposals will require modifications of the existing UCITS directives. These changes and any further changes required to take into account the evolutions and frequent innovations of the market should be made following a method enabling to respond as quickly as possible to the needs of the industry.

This is not possible at present since the two existing directives are very detailed as they were adopted before the implementation of the Lamfalussy process. The solution recommended by the European Parliament (based on the recommendations of the Klinz report) would be to apply the Lamfalussy principles to the modified dispositions without modifying the complete contents of the directive.

Three additional initiatives are necessary from a regulatory perspective to fully leverage the proposals made:

- Clarify the split of responsibilities between asset managers and distributors
- Define how to ensure equivalent market conditions for UCITS and competing savings products
- Specify the potential fiscal evolutions that may be needed to support the necessary evolutions

Additional market-led initiatives are necessary to make proposals for:

- The adequate split of responsibilities between asset managers and distributors and evaluate more precisely the related legal and economic impacts
- The improvement of the processing of funds at the EU level particularly in the context of the development of open-architecture models.

These market-led actions need to be further coordinated at the EU level to favour their implementation and should be put in the perspective of a common medium term target for EU funds distribution and processing that is lacking at present.

This target should take into account the current solutions developed by EU market players, the competitive positioning and interests of the different market players and the potential benefits for investors. This should enable to develop a pan-European roadmap for the optimisation of distribution and processing integrating the present market-led initiatives.

Main questions to be addressed during the workshop:

- What are the main issues and stakes of the EU UCITS industry, what are the main issues for investors and in particular retail investors (in relationship with the focus of the conference) ?
 - Position of the EU UCITS retail market and macroeconomic stakes: size, employment, position vs other savings products and vs pension issues, position of the EU industry vs the US
 - Main needs of investors and in particular retail investors related to UCITS in the EU: types of products expected, level of information and advice...
 - Do investor needs differ across the EU ?
 - What benefits are expected from further integration of EU markets, what concerns can this raise for retail investors ?
 - How to ensure access of investors to innovation?
 - Is the growing heterogeneity of UCITS investment policies and the development of open architecture solutions an opportunity or a threat for retail investors ? Are retail investors equipped to select the investment funds that best meet their needs ? What steps are needed to assist retail investors in this context ? Is the simplified prospectus part of the answer ?
 - Competition from other savings / investment products: is regulatory arbitrage diverting investment flows from UCITS towards competing products such as certificates or structured products ? Are any actions needed to address arbitrage or mis-selling risks ?
 - Main issues for the industry players positioned on different steps of the value chain (asset managers, distributors, custodians, fund processing and administration players...): development of an integrated EU market, development of the EU funds market outside Europe...
- To what extent do the existing proposals made for improving the efficiency of the EU UCITS market within the EU (responses to the Green Paper, output of the 2 expert groups, EFAMA proposals) enable to answer the needs of EU investors and in particular retail investors and of EU market players:
 - What is the present progress of the on-going proposals: what proposals are clearly spelled out ? what proposals still need clarifying and on what issues ? are additions needed ?
 - What benefits and concerns can the present proposals bring to retail investors and to the different industry players involved in retail markets ? What are the steps and conditions that need to be in place in order to have confidence that cost reductions will be ultimately passed through at least partly to investors ?
 - What priorities from a retail perspective: retail investors and retail market players ? more specifically, would the current proposals favoured by the industry (mergers, pooling (eg virtual pooling, master-feeder), management company passport, notification) significantly improve the operation and performance of the European fund industry and in what way ?
 - Is the on-going work on the clarification of eligible UCITS assets sufficient to render the UCITS provisions relevant to the current market context ? do

- rules on UCITS investment policy still offer meaningful safeguards for investors ? Which rules / principles remain relevant ?
- Are the different proposals well articulated: for ex: MiFID with EC Green paper proposals
 - Are any additional improvements not covered by present proposals needed ? what could be their potential benefits for retail investors and retail industry players and what success factors ? what are the potential barriers to their development ? what potential actions needed for their development and implementation (market, Commission) ?
 - What are the prospects of the development of open-architecture and third-party distribution concepts ? Will it advantage the retail investor ? What further actions are needed to implement the concept efficiently within the market ?
 - Optimization of fund processing within the EU: how badly is simplification of the current “spaghetti” junctions needed (between fund managers, transfer agents, distributors and other valuation / administration agents) ? what are the prospects for market-driven solutions over the short or medium term ? how to coordinate and implement on-going market-led actions ?
 - Could a pan-European advertising and distribution code of conduct to clarify the roles of asset managers and distributors guarantee an appropriate level of advice and make sure that advertising is not misleading ? How could it be developed and implemented ?
 - Is further action required to reduce distribution costs that is a cost-centre of the investment funds value chain ? What steps are needed ?
 - What potential actions are needed to make sure the priority existing proposals can be implemented in a reasonable timeframe and in a homogeneous way throughout Europe?
 - What supervisory and regulatory needs and concerns do these proposals raise ? Is it possible to increase the homogeneity of local regulatory requirements ? Are the recommendations of the CESR Himalaya report adequate ?
 - Is the Lamfalussy process an appropriate lever to tackle innovation challenges and issues related differences in the regulatory environment ? Would the proposals made in the Klinz report (ie a modification of certain focused dispositions of the Directive integrating the Lamfalussy principles) be an efficient solution ? How could these proposals be implemented efficiently ?
 - How to overcome the potential fiscal issues which stand in the way particularly of solutions of fund mergers and pooling and capital raising by funds which are not recognised as being fiscally transparent ?

The market of investment funds in the EU is developing strongly and has become a major component of EU capital markets.

Over the recent years investment funds and UCITS (1) in particular have become a major component of European capital markets (2).

- At the end of 2005, 6.600 B Euros were managed through funds domiciled in the EU representing 34% of the worldwide funds industry. UCITS funds represented 79% of this total with 5.200 B Euros managed through approximately 29.000 funds (source: EFAMA statistics).
- The market growth in Europe has been very strong over the recent years with:
 - o +23% progression of net assets managed in investment funds in general and UCITS vs 2004 .
 - o +220% progression of assets managed in investment funds and UCITS vs 1998.
 - o A nearly four-fold increase in assets managed since 1994
- The EU funds market is progressively catching up with the US: between 2001 and 2005 the funds market has remained stable in the US whereas it has strongly risen in the EU. As a result in 2005 the US market was only 50% larger than the EU market when it was more than twice the size of the EU market in 2001. The net flows of funds in 2005 were equivalent in the EU and in the US.

In terms of domiciliation, Luxemburg and France represent 49% of net assets of the EU UCITS industry (27% for Luxemburg and 22% for France). Ireland is the third country with a 9% share of UCITS assets (source EFAMA).

Still in terms of domiciliation, Luxemburg and Ireland recorded the highest growth rates among the leading UCITS countries with respectively + 35 % of growth for each in 2005 compared to 2004.

Regarding the location of financial investment management, the geography of players is rather different with 52% of net assets represented by France, Germany and the UK for investment funds domiciliated in Europe (source AFG EFAMA).

In certain countries more than 20% of households have savings invested in investment funds.

Equity funds represent the highest proportion of assets (44% with an increasing trend) followed by bonds funds (20%) and money market funds (20%). At present funds of funds represent 3,7% of total assets in the EU.

(1) UCITS: Undertakings for Collective Investments in Transferable Securities.

The UCITSs legislation governs how a fund can be marketed with the European Union and is designed to allow cross border fund sales to investors of different nationalities. To obtain UCITS status a fund must invest within defined but wide parameters. The fund may then be sold in any EU country, subject only to the marketing rules of that country. The funds are often umbrella funds based in recognised European offshore centres such as Luxembourg or Dublin. A non-UCITS fund, such as a hedge fund, is not allowed to be actively marketed within the EU at present.

(2) Europe's fund management industry holds and manages approximately 15% of Europe's total wealth measured as a % of GDP

Investment funds are considered to be a priority investment vehicle for future pension savings in most EU countries as they enable individual investors to benefit from a balance between medium / long term performance and a controlled level of risk (through adapted asset allocation in particular). This should ensure a sustainable development of investment funds and UCITS in particular in the coming years.

Further integration of the EU investment funds markets is necessary to develop cross-border marketing of funds and to increase the economic efficiency of the industry leading to potential price reductions for investors

Recent European Commission statistics show that integration of the UCITS market has progressed in the recent years. The number of cross-border funds has more than doubled since 1998. Today around 17% of UCITS are true cross-border funds and are attracting an increasing share of new sales.

However, the EU investment funds industry remains highly fragmented at all stages of the value chain (production / asset management, distribution, order processing and settlement) (see Appendix 1).

This hinders the capacity for industry players to market their products across Europe, develop further synergies and leverage potential economies of scale. This also means full economic efficiency of the EU market is not exploited to the benefit of investors at present.

Fragmentation therefore is a potential obstacle to the long term development of the EU fund industry and to its competitiveness vs the US in particular:

- The EU market is still dominated by funds of sub-optimal scale. The average size of EU funds is indeed 5 times less than comparable US funds and their average size is stagnating whereas it is progressing in the US (the US has 3 times less funds than Europe for a larger market share of the world market). Potential economies of scale are therefore reduced to the detriment of prices charged and interests served to investors.
- Distribution is also insufficiently integrated due to heterogeneous advertising and customer protection regulations and to differing tax regimes. These differences can potentially undermine the benefits brought by EU passports by creating additional obstacles to cross-border marketing of funds.
- Finally, the organization of the processing and settlement of transactions is also very fragmented within most local markets except Germany and France and across Europe in general. This leads to high costs and operational risks due to insufficiently automatized processes.

The potential cost savings of cross-border funds mergers, in the EU alone, were estimated in the report published by Invesco in 2005 (1) to:

- 2 to 6 B E per year due to economies of scale (depending on the scale of consolidation)
- 1.1 to 2.6 B E per year through lower administration costs in having fewer funds in each domicile

(1) Report of an independent investment industry research group led by Invesco (January 2005)
Benefits of an integrated European Fund Management: cross-border merger of funds, a quick win ?

The development of open-architecture that is a potentially strong growth driver for the industry is a further argument to foster the implementation of a truly integrated EU funds market.

Although integrated distribution (ie banks distributing in-house funds produced by their asset management subsidiaries) is still the norm in most EU markets except the UK where the role of Independent Financial Advisors (IFAs) is very strong, different concepts of open architecture are developing at present:

- In France, Spain and Italy open-architecture has developed so far mainly through multi-management (funds of funds) through which banks or insurance companies manage fund wraps that include their own products as well as products from the competition. This enables banks to better control the products they distribute (risk / performance level of the products, brand) while providing their customers with a broader range of products and with optimized asset allocation. Certain industry players also consider that this model limits certain risks related to a totally open architecture model (fund supermarket) ie difficulty and cost to provide appropriate advice for a large range of products, difficulty to determine responsibilities of asset managers and distributors vis-à-vis the investor...
- In Germany the predominant model is “guided open-architecture” through which banks distribute their own products as well as products from a limited number of partners
- In the UK a more open concept of funds supermarket has developed through IFA networks and with a strong proportion of fund-of-funds.

A certain number of key drivers are influencing third-party distribution and consequently the emerging of these different open architecture models:

- Investors have better access to information which has enabled them to improve their understanding and knowledge of mutual fund products.
- Active investors are increasingly looking for the best products available and in several fund categories there is a significant spread of performance across the products available in the market (eg in April 2006 the 3 year performance net of fees of all European equities funds available in France ranged between 21% and 234% with a median of 81% while volatility ranged between 5 and 20% with an average of 11% during the same period - Source Europerformance).
- Asset managers are rationalising their range of products to improve their profitability and specialized asset managers are developing.
- Distributors are seeking opportunities for differentiation.

As a result open-architecture products already represent a significant proportion of the market. For example fund-of-funds represented around 27% of the retail net sales in the UK market in 2005 (source IMA).

Further development of these concepts is considered by most industry players to be a long term trend and should benefit investors by:

- increasing the diversity of products they can invest in and the potential for asset allocation (open-architecture increases sources of diversification of assets on three dimensions: funds, fund managers and management styles)
- enabling investors to access “best-of-breed” products
- reducing prices and commissions by increasing the level of competition.

This should lead to improve average risk / return ratios at a better price for the investor.

Some industry players however point out that the conditions required to make sure that open architecture develops to the benefit of retail investors need to be clearly defined and implemented: adequate level of advice, sufficient transparency in costs and commissions...

These evolutions should also benefit industry players by triggering further investor demand. They should also enable them to build in the long term a more efficient business model enabling:

- Asset managers to specialize on certain product lines on which they can increase their scale
- Generalist players to optimize their overall revenues and costs related to asset management and distribution.

But open-architecture will not develop efficiently throughout Europe unless the EU market is further integrated.

The two existing UCITS directives have not enabled so far to implement a really integrated EU market due to heterogeneous transposition in the different member states and to insufficient integration of product innovation (hedge funds, private equity funds, real estate funds) and of needs expressed by the industry (management company passport, pooling techniques). A White Paper is being prepared by the Commission to improve the present legal framework.

The first UCITS directive published in 1985 introduced the concept of a European passport for funds based on a mutual recognition principle (ie the agreement given in one Member State for a fund should be accepted by another member state with no further requirements). This directive was transposed in a heterogeneous way throughout Europe limiting its impact.

This leads asset managers to regularly face additional requirements when they export their products to another member state which slow down the notification process and increase the costs incurred by industry players (additional registration and maintenance costs, certified translation costs, local legal adviser fees...). Indeed once authorized in its home state and once a "certificate" has been issued by its home state regulator, the management company has to liaise with the host regulator to notify the fund registration file which often leads host regulators to request additional information and documents.

The high legal and administrative costs of navigating these additional requirements were estimated by the industry to represent a recurring cost of 25 M E (source IMA and EFAMA), to which could be added the unquantified costs related to adverse time to market and subsequent missed opportunities.

It is often considered that the 1985 UCITS directive that aimed at creating an integrated market for investment funds has in fact so far contributed more to the growth of the industry at the national level giving financial institutions the opportunity to produce and distribute locally a new type of savings vehicle stamped with a EU label of quality and security. However this has enabled UCITS to become a widely

recognized label throughout Europe that is a potential stepstone towards further integration.

In January 2002 two new directives were adopted:

- The “products” directive enlarges the range of assets UCITS can invest in (investment in other funds, use of derivative instruments ...)
- The “management company” directive enables management companies both to market their products throughout the EU with no further requirement once they have received an appropriate agreement in their home country and avoiding duplicating heavy local structures, and to use in theory a so-called management company passport (i.e. to manage a fund domiciled in another Member State). It also introduces a new simplified prospectus (standard information document) and reinforces the capital and organizational requirements for management companies.

These new dispositions could potentially bring progress but following their implementation divergences have appeared among Member States on the way they should be interpreted and implemented locally as pointed out in the “Klinz report” (European Parliament April 2006). Member States tend to have a more or less flexible interpretation of these dispositions.

The so called simplified prospectus is also often criticized as being too complex and long (average of 6 to 10 pages).

In addition the implementation of the “products” directive raises feasibility issues due to the continuous innovation of the industry. According to the Expert group on asset management established by the Commission in 2004, 30% of the fund industry operates without the benefit of any over-arching EU legislative framework. The existing legislation does not apply for example to hedge funds, real estate funds and private equity funds.

Moreover, the management company passport cannot work in practice due to internal inconsistencies of the provisions of the Directive and pooling techniques such as virtual pooling and cross-border master feeders are not clearly permitted at present.

A certain number of additional missing issues were also put forward by the expert group set up by the Commission in 2004:

- How to adapt the regulatory framework to constant product innovation ?
- Is there a need for a depositary passport ?
- How to create a level playing field with comparable products competing with UCITS (eg structured products, certificates...)?

Following these reactions and industry proposals the Commission decided to complete and precise the present dispositions through a White Paper announced for the end of 2006 that is being prepared through:

- The contributions to the Green Paper received at the end of 2005
- The coming conclusions of the two expert groups set up in the spring of 2006 (cost-efficiency, alternative investment funds).

Proposals were made in the Klinz report to modify certain priority dispositions of the current directive and to apply to them the Lamfalussy principles to them

The current UCITS directives are only partly included in the Lamfalussy process as they were adopted previously. No substantial modification to the legal framework is possible at present without amending the directive which is a very long and complex process. In order to ensure a flexible legal framework taking into account the strong level of innovation of the industry market players consider it is necessary to find practical solutions that allow Lamfalussy principles to be introduced.

The Level 2 of the Lamfalussy process offers in particular tools which would allow adapting the UCITS directive to industry developments even if the scope of possible modifications at Level 2 are limited due the high level of detail of the dispositions of the current UCITS directives.

In this context, the European Parliament (Klinz report) recommends to modify certain priority areas of the directive and to apply the Lamfalussy principles to these dispositions. This would enable to make the main changes required while avoiding modifying the whole directive and would therefore speed up the process considerably:

- Implementation of a simplified prospectus
- Modification of the notification procedure
- Abolition of tax barriers for cross-border mergers and pooling
- If appropriate, adaptation of eligible assets to market developments

A certain number of additional initiatives led by the Commission and the market should enable to go into the right direction

The Commission has set up following the consultation on the Green Paper 2 expert groups responsible for making further recommendations in preparation for the White Paper on 2 topics:

- “Cost-efficiency”: The objectives of the expert group are to advise the Commission on cost-effective ways to support a more efficient organisation of different stages in the European funds value chain. The issues addressed relate in particular to:
 - o the implementation conditions of the funds passport and of the management company passport
 - o the development of cross-border fund mergers, the choice of appropriate pooling techniques (eg virtual pooling, master-feeder...) and the possible implementation of a funds depository passport
- “Alternative investment funds”: The objectives of the expert group are to advise the Commission on matters relating to the European market for Hedge Funds and Private Equity funds. This group is missionned to describe the current trends and issues related to these products, identify and document the different barriers hindering the efficient development of alternative investment funds on a cross-border basis and propose solutions when possible for overcoming the cross-border barriers identified by the Group.

The conclusions and recommendations of these 2 groups are due for June 2006.

Several significant initiatives led by the Commission, the European Parliament, some member states and the industry should also be mentioned:

- The European Parliament expressed its views on the existing UCITS directives and on the related regulatory process in the Klinz report published in April 2006
- The MiFID regulation to be implemented by the end of 2007 should impact the distribution of investment funds in the EU through a set of conduct of business requirements that should apply to investment funds in particular:
 - o Client classification
 - o Fair, clear, not misleading and clearly identifiable marketing communications
 - o Information about the firm and its services
 - o Know your customer and suitability requirements
 - o Limitation of execution-only services
 - o Record-keeping of client agreements and possible requirements on the content
- Initiatives conducted by certain Member States such as the Delmas-Marsalet report published in France in 2006 that put forward recommendations for the splitting of responsibilities between producers and distributors:
 - o Ensure better information on products and their evolution
 - o Improve the distribution of funds
 - o Provide appropriate advice
 - o Clarify responsibilities among market players
 - o Improve customer services
- Market-led initiatives such as the recommendations published in 2005 by EFAMA related to the standardization of funds processing (order processing and settlement) in Europe to improve efficiency in European domestic and cross-border funds markets. At the heart of the recommendations is the move to STP (Straight-Through-Processing) with firms communicating electronically using messages constructed to international open market standards (ISO 20022) and with universally recognized unique identifiers used whenever possible. EFAMA also recommends that fund management companies summarize key information relating to their funds in a "Funds Processing Passport" in order to facilitate their trading. Other recommendations relate to the adoption of common standards relating to the different elements of the process (account opening, order placement, order confirmation, settlement). These recommendations are due for implementation in 2006 at the national level under the steering of EFAMA.
- The report chaired in 2005 by Invesco defines the conditions required for the development of cross-border mergers of funds in the EU, considered as an important and pressing issue by many market players to reduce market fragmentation. A case-by-case negotiation between the key pan-European players and related regulators is favoured to a regulation to speed up the process.

These different initiatives are very promising for the development of an integrated EU funds market. However many industry players believe that beyond adapting the existing UCITS Directive to their needs, additional actions are necessary to enable the funds market to develop sustainably in the long term in the EU:

First of all, one should ensure that the recommendations put forward in the different initiatives listed above are effectively and consistently implemented throughout the

different member states. In particular the heterogeneity of the action of the different local regulators is often put forward as a potential obstacle for effective implementation of the fund and management company passports (ensure a level playing field in regulation, prevent the need for additional requirements by certain regulators once a fund has been registered in a Member States due to potential divergence in the interpretation of law for example).

Market players also point out that fiscal issues should be addressed.

The fiscal regimes of the 25 member states are different: the rate of taxation varies as well as the manner in which taxes are levied and the assessment of tax liabilities. This explains partly the proliferation of funds in the EU according to the 2005 Invesco report: fund providers register locally domiciled funds in many different markets without which they would be unable to sell within each different tax jurisdiction. The different local fiscal dispositions across the EU hinder economies of scale and represent potential barriers to entry into foreign markets:

- administrative work and related costs for having to comply with different fiscal systems: for example obtain annual certification that the fund has met certain conditions to benefit from advantageous tax treatment
- differences in fiscal treatment between domestic and foreign- based funds

According to the EFAMA report on tax discriminations against foreign funds these possible discriminations indeed take two main forms:

- Tax reliefs that are only available to investors in domestic funds and not to those same investors in foreign-based UCITS
- Tax rules which are applied only to foreign-based UCITS and not to domestic UCITS which have some adverse tax effect on investors in foreign UCITS.

Market players consider that fiscal regimes should be further harmonized through a generalization of mutual recognition agreements in a first stage and through a clarification of the tax advantages brought by the different legal statuses of funds in each country (to be completed).

In addition, the European Commission expects market players to take further action for improving the conditions of the distribution of funds and their processing to enable the implementation of an integrated EU funds market and the development of open-architecture solutions : **a certain number of market-led actions should be set up or enlarged at the EU level:**

- **A clarification and a harmonization of advertising and distribution practices across EU countries seem necessary to guarantee that investors have a sufficient level of protection.** Indeed confronted with increasingly complex and diversified products customers should be provided with appropriate information, advice. Distribution networks need to be sufficiently trained and equipped with the adequate tools to tackle these evolutions and in particular open architecture. The dispositions of MiFID when they are consistently throughout the EU implemented should enable to make progress but a pan-European advertising and distribution code of conduct could be a useful addition to define more precisely the arrangements that industry players need to put in place.
- **A clarification of the respective roles of asset managers and distributors also seems necessary.** At present the split of responsibilities is perceived as unclear by many market players: asset managers are asked to be able to monitor to a certain extent their distribution, transaction and depositary processes which

is difficult for the smaller management companies in particular and in the context of open architecture.

- **The implementation conditions of open architecture solutions also need to be clarified and closely monitored** to make sure that customers are sufficiently protected and to make sure they benefit from the potential performance brought by open architecture: adequate level of advice, sufficient transparency in costs and commissions... are required
- **An optimization of fund processing (processing and settlement of transactions, deposit) also seems necessary to improve the cost-efficiency of the industry and reduce its operational risk.** This is particularly the case for cross-border transactions and for local markets except France and Germany. Different market-led initiatives are triggering progress on these issues:
 - The EFAMA proposals for standardizing the processing of funds mentioned above
 - Discussions around a possible EU funds depositary passport

These market-led actions need to be further coordinated at the EU level to favour their implementation and should be put in the perspective of a common medium term target for EU funds distribution and processing that is lacking at present. This target should take into account the current solutions developed by EU market players (1) and enable to develop a roadmap integrating the present market-led initiatives.

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(1) For example the outsourcing or centralized solutions implemented by providers such as Euroclear and Clearstream to facilitate funds transaction processing and settlement or the different open architecture platforms developed by different market players

Appendix 1: Investment funds value chain

Investment funds value chain

