

Optimising cross-border distribution and processing of investment funds in the EU

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Executive summary of the Eurofi initiative

1. Eurofi worked over the last 12 months with a representative group of fund industry leaders covering the different steps of the value chain¹, to make proposals for improving cross-border fund distribution and processing in the EU:

UCITS funds are a booming market in Europe:²

- At the end of 2006 €7550 billion were managed through investment funds domiciled in the EU representing 34% of the worldwide fund industry. UCITS funds represented 79% of this total with €5900 billion managed through approximately 31000 funds.
- The market growth has been very strong for UCITS and sustained over the recent years: +80% growth between 2003 vs 2006 and a two-fold increase since 1998.

Cross-border and third-party fund distribution is developing in the EU³:

- Cross-border funds (ie registered in 5 countries or more) represented around 30% of net asset flows in 2005 and intra-EU cross-border fund transactions are considered to represent around 20% of total transactions in the EU
- Major distributors evaluated that in 2006, 55% of their activity was third-party with 35% in foreign funds.

Many operational and legal obstacles limit at present the efficiency of UCITS cross-border distribution and processing in the EU. These obstacles are becoming increasingly important to address as cross-border and open architecture distribution develop. Solving these inefficiencies could further enhance the competitiveness of the EU funds industry by reducing complexity and eliminating certain operational risks and extra-costs.

The EU Commission has focused the proposals made in the White Paper on activities related to regulatory compliance, management company overhead and asset management which are considered to represent around 15% of total costs and on some components of distribution (total distribution costs were evaluated to represent 60% of total costs)⁴.

¹ The following institutions were part of the Eurofi working group co-chaired by W. Klinz (MEP), E. Corley (Allianz GI) and A. Papiasse (BNP Paribas) :

- Banks (including asset management and processing entities): BNP Paribas, Unicredit Group / Pioneer AM / Bank Austria Creditanstalt, Crédit Agricole, Fortis
- Asset managers: JPMorgan AM, Natixis Global Associates, Union Investment, HSBC IM, Allianz GI, DWS
- Processing service providers: Citigroup, Schroders, Société Générale, CACEIS, State Street,
- Stock exchanges: Euronext, Bourse de Luxembourg

² Source : EFAMA statistics

³ Source FERI statistics and FERI 2006 European Fund Buyer Survey. A rising proportion of UCITS are also sold outside the EU (around 15% of net sales)

⁴ Source: CRA study September 2006 - average production and distribution costs for equity funds in a sample of EU markets . CRA estimated that total production and distribution costs amounted to ~150 bp on average in a sample of EU countries. The study did not cover the whole value chain (eg trading costs are not included). We were not able to verify the validity of these costs or the methodology used, but these results give an indication of the breakdown of costs.

Asset management costs comprise: cash management, research, asset allocation, operational asset management and dealing decisions. Processing and administration costs cover fund and client administration, regulatory compliance of the fund and management company overheads and systems. Distribution and marketing costs cover new product development, compensation to distributors, documentation, promotional activity...

Many inefficiencies or obstacles in UCITS order processing and fund administration⁵ will not be addressed by the projected changes in the Directive. Processing and administration costs nevertheless represent a significant proportion of the total costs (around 25%) and could be an obstacle to the implementation of certain proposals of the White paper.

In addition, the specificities of investment funds need to be correctly taken into account in the implementation of MiFID. MiFID may also increase the impact of differing legal frameworks between UCITS and competing investment products (eg notes and certificates) according to many asset managers eg by increasing the disparity of disclosure requirements and creating potential regulatory arbitrage.

To solve these different issues, Eurofi set up in October 2006 an initiative involving 18 representative institutions active in cross-border fund distribution and processing and positioned on the different steps of the value chain (ie production, distribution and processing of UCITS) and steered by W. Klinz MEP, E. Corley (Allianz GI) and A. Papiasse (BNP Paribas) to make proposals for improving cross-border fund distribution and processing in the EU.

The Eurofi working group decided to focus its assessments and recommendations on three main topics:

- Accelerating the automation and standardisation of cross-border processing activities (order execution, settlement and commissions tracking)⁶
- Improving the level playing field between UCITS and competing investment products and an appropriate implementation of MiFID for UCITS funds.
- Evolutions required in depositary and fund administration services to enable the implementation of the White paper proposals and to foster further harmonization and economies of scale in these activities

2. Main recommendations made by the Eurofi working group:

2.1. Processing issues: Accelerating the automation and standardisation of cross-border processing activities (order execution, settlement and commissions tracking)

Main conclusions of the Eurofi group:

Three major “technical” issues were underlined by the Eurofi group:

- Insufficient automation of cross-border order processing:
 - Although automated orders are the norm in many cases for domestic deals, manual orders still represent around 50% of cross-border intra-EU deals and cost 2 to 4 times more to handle than automated orders
 - Total end-to-end costs of executing cross-border orders is around 20 to 50 Euros for manual orders within the EU compared to 3 to 15 Euros for automated orders⁷

⁵ eg lack of automation and standardization in cross-border order execution and settlement and in third-party commission tracking, evolutions required in the processing organizations of some EU countries to adapt to cross-border business, differing oversight and asset safekeeping functions across the EU...

⁶ The work of Eurofi is complementary to the initiatives led by EFAMA in this field. EFAMA indeed defined in 2004/ 2005 with a group of asset managers and processing agents a set of standards for fund processing and recommended implementing a standard template containing the necessary information to process fund deals ie the Fund Processing Passport (FPP) in 2006. Eurofi worked with a group of players active in a wider range of activities (ie including distributors, custodians and stock exchanges as well as asset managers and processing agents) to define the actions required to accelerate in particular the implementation of the EFAMA proposals in the market and to identify additional suggestions that could be made to further improve fund cross-border processing in the EU, given the latest developments in automation and cross-border distribution.

- Third-party distributor commissions are not handled efficiently in most cases: tracking and reconciliation of commissions are time-consuming for all players⁸ due to the lack of standardization in data and processes, manual processes involving different counterparties and varied and continuously evolving commission structures and calculation methods
- Evolutions are required in the practices and organisations of different EU markets to handle more efficiently cross-border orders in all market environments: more flexibility required in the order execution and settlement organisations particularly of CSDs countries, close monitoring of risks associated with large sized cross-border orders particularly in TA countries⁹.

The present differences in the processing organisations of different EU countries are an additional factor of complexity but the Eurofi group did not wish to suggest imposing a possible common target model for EU processing organisations¹⁰.

From a broader perspective, insufficient automation and standardization in fund processing can also be explained by:

- The fragmentation of the industry at all levels of the value chain. This is particularly detrimental for fund cross-border processing where competing solutions have been developed by many different players (TAs, ICSDs, stock exchanges, etc...), using different processes, sometimes different standards, with resulting vested interests and differing views on the solutions required
- The insufficiently attractive business case of cross-border automation so far for many small and medium sized players or large domestic players. This should improve as open architecture opportunities develop and as an increased number of players use automated solutions.

Significant improvement is expected in the level of automation of cross-border order execution in the coming 3 to 4 years: the objective expressed by the majority of the study participants is to be able to automate around 80% of deal executions in the EU (order routing and confirmation) by 2011: around 50 to 60% via bilateral exchanges¹¹ and the remaining 20 to 30% transiting via processing hubs¹².

⁷ Depending on the organization and whether there are errors that need to be corrected – and according to the statistics provided by the members of the Eurofi group

⁸ Asset managers commission distributors for the sales of investment funds (distribution, handing of orders, information and advice provided to the investors...) usually based on the volume sold. The data for each distributor is usually provided by the distributor or the custodian and reconciled with the data held by the TA or centralizing agent (in CSD countries) and by the asset manager. This process is mostly manual at present with each custodian and distributor using specific formats.

⁹ Two main models exist in the EU: the CSD model where orders are executed and settled through the CSD (eg France, Germany, Austria, Denmark...) and the TA models where transfer agents execute the orders (eg Luxembourg, Ireland, UK, Italy...). The main advantages of the TA model usually put forward are the direct relationship between players for all layers of the entire processing chain. The main advantages of the CSD model are its high level of security due to DVP settlement and the centralized processing of settlement.

¹⁰ There was insufficient consensus on this issue in the group. Some participants considered that market organisations should progressively converge towards centralized order execution and settlement of orders and extended position keeping capabilities with a combination of the best features of the CSD and TA models (in relationship with some evolutions already under way in certain markets). Others believed that predetermined solutions should not be imposed on the market and that multiple models could bring efficiency enabling fund agents to adapt to different models inside and outside the EU.

¹¹ 40% should be using Swift messages (XML enabled) and 10 to 20% bilateral FTP or proprietary standards by 2011

¹² Some players point out that this objective may need to be re-assessed in the future, as the distribution of UCITS opens up to new players outside the EU eg in Asia who are not automated. This implies that processing

In addition they point out that different technical solutions exist or are being developed in the market to enable players of practically all sizes to automate and centralize cross-border order routing¹³.

But around 40% of cross-border deals could remain manual or using non-harmonized protocols (FTP, proprietary formats), according to the players part of the Eurofi group, if no specific action is put in place to encourage small / medium sized distributors who are responsible for most manual order input to adopt automated solutions.

The extra-costs of insufficient automation and standardization are borne by asset managers mainly who pay higher charges to their processing agents (transfer agents and centralizing agents) for orders handled manually.¹⁴.

Recommendations made by the Eurofi working group:

1) Accelerating automation of order processing and the implementation of common processing standards:

- Setting up an automated process to support cross-border notification and authorization of UCITS, enabling prospectus data to be captured once and made available automatically across the EU
- Facilitating the access to standard and reliable prospectus and processing data (Fund Processing Passport data) for all providers and in particular third-party distributors and processing agents. Different operational scenarios need to be further assessed: some players believe that this could be done through a central database concept at EU level (possibly focused on processing data for cross-border funds), others consider that the data can be maintained at country level provided common templates are used and that a centralized process and/or body are put in place to maintain the data and ensure its reliability¹⁵.
- Implementing incentives should be considered to encourage small / medium sized distributors or local distributors with limited cross-border activity to automate their order input. This should enable to reduce the remaining manual orders and the proportion of deals using FTP or proprietary standards and the related extra-costs for market players. These incentives should be market-wide not to advantage specific funds based on their processing arrangements, possibly limited in time and compliant with MiFID rules¹⁶.

agents will need to retain a capacity to process manual orders anyway and may slow down the overall automation process to a certain extent.

¹³ Different solutions exist to facilitate automation of cross-border orders (provided by TAs, ICSDs, distribution hubs, Swift...): Swift-based solutions or interfaced hub solutions for the large players (Swift is developing XML enabled fund specific messages (20022 messages) that should facilitate standardized order execution, and soon settlement and commission tracking); web-enabled interfaces or FTP for medium-size players; web browser solutions for smaller players. Cross-border solutions are operated by processing hubs and TAs in particular. Swift is planning to launch in the second half of 2008 a light connectivity version with 'plug and play' characteristics targeted towards smaller users.

¹⁴ As a reference, total extra-costs of manual processing were evaluated by Swift in 2005 to amount to more than €1 Bio per year to which could be added indirect costs of €3 to 4 Bio due to higher error rates, potential loss of customers, etc...

¹⁵ Databases exist in different EU countries containing prospectus data although most of them are considered to be incomplete (except for the Luxembourg based CCLux and the database maintained by the French regulator). Projects are being developed by certain domestic asset management associations to create portals or databases to support the implementation of the FPP (eg in the UK, in Luxembourg, in France...)

¹⁶ The rationale of this proposal is to encourage distributors to progressively invest in automated order input solutions upstream to progressively reduce the costs paid by asset managers down the value chain for the manual processing of orders with the related error rates. Indeed, as mentioned above the extra-costs of manual

- Swift should make sure that the timeframe for the switch from 15022 to 20022 messages, which facilitate automation and standardization through a wider range of fund specific messages, is respected by the users and should carefully monitor upgrades and domestic variations to foster as much standardization in messages as possible in relationship with user needs¹⁷.

2) Broadening the scope of standards defined:

- Commission tracking: Defining a commonly agreed codification of distributors at the right level of granularity seems to be a priority¹⁸. In addition a code of practice for further increasing standardization of distribution agreement formats and of processes for providing the data could be created¹⁹.

- Settlement deadlines (for dealing investment fund shares) could be harmonized within the EU around T+0 for cash and T+3 for other instruments. When a more favorable standard already exists locally it could be maintained (eg T+2 in Germany, Austria...). The implementation conditions of this proposal need to be further assessed taking into account the different local situations within the EU, cases where the investor is outside the EU, the different types of funds, etc....

3) Some evolutions could be considered in the practices of the different markets to adapt them better to the handling of cross-border orders:

- CSD organizations need to become more flexible according to many cross-border users part of the Eurofi group and to adapt more to the specificities of the fund industry: in the criteria to be met to access the CSD systems²⁰, in the transparency of costs or in the rules used by CSDs eg in DVP settlement²¹. Some evolutions may also be required in roles and responsibilities to enable fund agents (ie centralizing agents in France) to manage more efficiently direct cross-border orders using arrangements similar to contractual settlement²².

processing by TAs and centralizing agents are covered by the asset managers who also pay retrocessions to the distributors.

¹⁷ Swift has recently decided not to launch further changes to existing messages (no new standards release) until the end of 2008. Efforts are also made through different formal and informal coordination groups (SMPG, Findel, AFAC...) to reduce the variety of messages across EU countries and in Asia and make sure formats are unified in each country. Swift Board members agreed in June 2007 to harmonize funds messaging around one single fund standard (ISO 20022 as recommended by EFAMA): all Swift FIN - fund template message (15022) users will have to be ready to use 20022 XML messages on SWIFTNet Funds by end Q1 2010 and to discontinue 15022 fund templates messages by Q4 2011. A full fund standard migration support programme is planned by swift to ensure automation rate is maximized.

¹⁸ Present BIC codes are often considered insufficient by industry players to identify the right distribution channels or agents commissions should be paid to. Codes agreed bilaterally between the distributor and the asset management company are often used to identify correctly the adequate distribution agreement and hence the final distributor leading to manual reconciliation, but they are not standard

¹⁹ standardization of certain legal terms of the commercial agreements, development of a common template for commercial terms, standard processes for providing the information, glossary with common definitions (eg definition of different rates, calculation types...) and some common "technical" rules for commission calculation eg definition of holdings used, rounding up rules...- but not a standardization of commission schemes

²⁰ eg based on risk and investor protection criteria rather than on the status of eligible members ie bank or investment company with sufficient capital, which would allow for example some TAs to participate directly to CSDs). Some participants point out that proposals for modifying access criteria (eg allowing access to institutions with lower capital) should be carefully handled to avoid increasing risks and that cross-border access is already possible as an affiliate to an existing member.

²¹ Rules could be modified to increase the efficiency of DVP settlement within the CSDs: eg extension of settlement timeframes, timeframe for redemptions, overdraft rules...

²² The way in which responsibilities and processes are defined in TA countries to manage direct orders could be a possible reference (responsibility carried by the management company with agreements in place to ensure possible recourse over the different counterparties and providers of the fund). The development of a position

- Risks need to be carefully monitored particularly in TA countries for third-party providers, according to some players, to avoid processing prices increasing, as Basel II requires capital to be allocated to operational risks. They recommend verifying whether capital requirements are sufficient and need to be harmonized²³ and to impose some market standards related to cash collection accounts and due-diligence processes²⁴

4) Setting up mechanisms at industry level to monitor progress in cross-border and third-party processing could be an additional driver:

- A common reporting could be put together at industry-level to measure the progress made in cross-border processing (ie measurement of the level of standardization and automation) and the evolution of the different drivers of further automation (ie costs, % of players equipped with automated solutions, etc...)

- The industry could also consider settling up a permanent forum representative of producers, distributors and processing providers to further monitor the progress made and work on common issues²⁵

3.2. Distribution issues: Funds distribution practices and comparability

Main conclusions of the Eurofi working group:

UCITS are distributed at present in two different ways: with advice generally for retail investors²⁶ and on an execution-only basis mainly for institutional investors..

Mutual funds compete with other investment products (particularly notes and certificates²⁷) that operate under different regulatory frameworks and can be presented to investors as similar products. This creates level playing field issues for UCITS and exposes retail investors to products that seem comparable while being potentially less secure. There is a strong concern in the industry that MiFID implementation may increase the disparity of disclosure requirements across competing products (subject or not to MiFID), increase the complexity of disclosure required from producers and create potential regulatory arbitrage while not increasing substantially the protection of investors in UCITS. This may have negative effects on the development of the funds market and on open architecture in particular.

keeping function in CSD countries as proposed by the "TA light concept being developed in France should help to solve the main issues involved with commission tracking and direct orders.

²³ Eg across countries and / or types of players (in relationship with passporting opportunities) and to impose some market standards

²⁴ eg imposing cash collection accounts in the name of the fund, ensuring that appropriate due-diligence processes are conducted, proposal of a template for contractual agreements...

²⁵ EFAMA and FEAM represent asset managers and their processing arms, ECSAs represent distributors and custodians / depositaries...but there is no representation for all the players positioned on the different steps of the value chain

²⁶ Retail investors are charged a front load at the time of subscription which is negotiable and an on-going management fee. Distributors receive a remuneration which covers the provision of advice and information, the handling of orders and the access to transaction platforms or service providers as well as the follow-up over time

²⁷ Life insurance contracts were not considered by the Eurofi group as directly comparable with UCITS. They are more a fiscal wrap to favour long term investment patterns and do not present the same problems for investors as notes and certificates (even though they will not be subject to MiFID), as they are already strongly regulated through EU level and local rules

The call for evidence launched in October 2007 by the European Commission on substitute investment products should help to complete these assessments²⁸.

Some additional points were made by the participants of the Eurofi group related to the application of MiFID requirements to UCITS:

- The type of disclosure²⁹ required needs to be considered seriously and should be harmonized across Europe to avoid in particular producers being subject to requirements they cannot fulfill (eg obligations going beyond the contents of the prospectus) and to not increase the disparity of disclosure between UCITS and competing products.
- The NAV at which UCITS deals are always executed already guarantees a fair price for investors. Therefore study participants consider “best execution” is already in place for the subscription of investment fund shares

Primary recommendations made by the Eurofi working group:

Align major rules for competing investment products ie UCITS / notes & certificates:

- Align information disclosure across competing investment products on the key elements of choice for investors as far as possible ie fees & costs (TER or equivalent), performance, valuation (NAV calculation funds or market value for certificates), risk (if appropriate)
- Align product set up and approval requirements for competing investment products targeted to the same retail clients

Clarify the debate on inducements and best execution to ensure that MiFID is appropriately implemented to UCITS funds

- Regarding the inducements debate: Retrocessions paid by asset managers to distributors on a on-going basis remunerate an added-value service and are necessary to facilitate the development of open architecture which is necessary for cross-border distribution and is in the interest of investors. The type of disclosure required needs to be considered seriously and should be harmonized across Europe to avoid in particular producers being subject to requirements they cannot fulfill.
- Regarding the best execution debate: The subscription-redemption process of open-ended funds (including UCITS) has the characteristics of a primary market: the value of units is determined according to the Net Asset Value (NAV) of the relevant fund which ensures de facto best execution. For some other funds such as ETFs (Exchange-Traded Funds) or closed-ended funds where secondary market transactions may take place, best execution rules may be needed.

Secondary recommendations made by the Eurofi working group:

Enhance when possible and appropriate the standardisation of key information delivered to investors at the point of sale for competing investment products³⁰

²⁸ In the document announcing the call for evidence, the Commission makes a certain number of statements that are in line with some assessments of the Eurofi working group:

“Continuing innovation in the structuring of retail investment products has meant that retail investors are now able to choose between a variety of different product types to meet their investment needs. However EU legislation applying to the institutions that originate these products imposes different rules on the product information that must be disclosed (for example on risks, charges and expected returns), and on the way in which financial intermediaries must conduct business with retail clients, and manage any conflicts of interest that may arise. Regulators, financial institutions and consumers have expressed concern that this might represent a threat to the protection of retail investors”.

²⁹ Payment of commissions and retrocessions to distributors will be allowed under MiFID provided they are disclosed by the distributors.

³⁰ Note: the two first recommendations below focus on investment funds. At a later stage this needs to be reviewed for competing products once disclosure is under way under MiFID

- Costs: Disclose method used for TER calculation for investment funds
- Valuation and performance: Fully disclose valuation methodology used and increase collaboration with data providers to enhance appropriate information and advice
- Risks: Some participants propose assessing the feasibility and added value of enhancing the harmonization of risk metrics for competing investment products

Longer term recommendations made by the Eurofi working group:

Some participants propose assessing with representative distributors and producers active in the EU the potential interest of clarifying responsibilities of producers and distributors at the EU level for competing investment products in relationship with the implementation of MiFID.

3.3. Depository and administration services optimization

Main conclusions of the Eurofi working group:

Asset safekeeping, custody and NAV calculation services are performed by depositaries, sub-custodians and fund administrators. Depositaries are appointed by the management company and have two generic functions: oversight and asset safekeeping. They are required by the UCITS Directive to be domiciled in the same country as the management company and by extension of the fund.

Missions of the depository are defined in broad terms in the UCITS III Directive but the lack of precise definition of these missions has led to diverging transpositions at the national level and many variations in the way the safekeeping and oversight functions are discharged across the EU.

These variations can lead to duplication of tasks (duplicate booking, duplicate NAV calculation or verification and controls...) ³¹ which limit potential economies of scale ³² and could lead to potential regulatory arbitrage among countries since depositaries are not submitted to the same obligations ³³.

Some initial measures (described as quick wins) were proposed by the Commission in the White Paper to allow more freedom in cross-border appointment of processing service providers: allowing branches from banks authorized in another Member State to act as depositaries, allowing depositaries to delegate assets' safekeeping to a custodian in another Member State. These measures are a step forward but need some clarification in the Directive of the rules to be applied:

- Given the lack of harmonization of the roles and responsibilities of depositaries in the EU, a branch should follow the local rules of the fund and in case of delegation of custody to a sub global custodian, this provider should follow the rules in place in the depository's home country ³⁴.

³¹ Delegation to a sub global custodian is not allowed in all countries (eg Italy, Germany) or limited (eg in Luxembourg safekeeping has to be delegated to more than one global sub-custodian). Some custody activities still have to be performed in the home country of the management company at present in certain countries: booking in the home country due to deposit-taking rules (eg Italy, Germany...) or asset replication rules (eg Belgium – nominee replication-, Lux, France)

³² This has an economic impact particularly for players entering new markets through acquisition or the creation of new subsidiaries or for medium-sized players who cannot spread their investments and costs across a wide range of countries and activities

³³ Eg the liability of depositaries is not totally equivalent across the EU: in particular the "asset restitution" in France is more specific and constraining than the obligation in place in most other EU countries: in most EU countries the depository is responsible for any prejudice the management company or investors may incur as a consequence of the depository's non compliance with the obligations related to the performance of the function

³⁴ Some clarification may be required for non-EU assets for which the application of such requirements may not be possible

- In addition the legal statute of depositaries could be harmonized as credit institutions³⁵ at the occasion of the revision of the Directive to enable all depositaries to benefit from branching opportunities and to solve present potential customer protection disparities across EU countries.

The Eurofi group also believes that the implementation of certain key features of the White paper should be considered on the depositary side to ensure that the depositaries or appropriate fund agents will be able to discharge correctly their responsibilities regarding the corresponding evolutions. For instance:

- Regarding Master feeder funds: the feeder fund agent may not have all the information required to perform correctly its function and may not be able to discharge correctly its duties (eg particularly related to fund compliance issues)
- Regarding Fund mergers: the responsibilities of the respective depositaries in the context of a merger of funds should be specified to enable them to perform correctly their adequacy test under the proposed new regime (eg the absorbing UCITS depositary may have to rely on data provided / certified by a depositary subject to less stringent or different oversight rules)

Short / medium term recommendations made by the Eurofi working group:

1) The implications for depositaries of the main features of the White paper and particularly master feeder funds and fund mergers need to be further specified by the Commission in the course of the review of the Directive, taking into account the issues mentioned above in particular.

2) Some improvements can also be expected by a clarification of the definitions of depositary functions, responsibilities and their legal statute of depositaries in the UCITS Directive. These improvements do not require implementing a depositary passport.

In this regard, focused changes could be made in some articles or sub-articles of the UCITS Directive related to depositaries³⁶ at the occasion of its revision in 2008. This should enable the following rules to be implemented consistently:

- NAV calculation requirements should be defined more precisely in the Directive to avoid double calculation: one control function exercised by the depositary, one calculation function exercised by a service provider or possibly delegated to the depositary
- Rules should be harmonized across the EU for allowing some processing functions related to fund administration services³⁷ to be delegated to cross-border service providers, provided that the current controls are maintained and are in line with the local law of the fund domicile.
- A more precise definition of depositaries as credit institutions with minimal capital requirement, with a possible grandfathering period, could also be considered.

The oversight function of the depositary should remain in the home country of the fund until full harmonization of depositary functions, roles and responsibilities is possibly implemented across the EU.

³⁵ At present a large majority of depositaries across the EU are credit institutions but some member states - eg UK, Ireland, the NL - allow companies that do not have banking licenses to operate as depositaries under certain conditions

³⁶ Eg Articles 1, 3, 5, 7, 8, 14, 15 of the UCITS Directive 85 / 611 / EEC

³⁷ as described in Annex II of the Directive (eg fund accounting services, maintenance of unit-holder register, valuation and pricing...)

Longer term recommendations:

Progressive harmonization of the different functions performed by depositaries is the longer term goal to achieve to avoid duplication of tasks and potential regulatory arbitrage:

In order to prepare this objective, the Eurofi group recommends that a Lamfalussy-style clarification process is set up to define more precisely and harmonize depositary functions and responsibilities and particularly those related to asset safekeeping and NAV calculation. A call for evidence could be launched by the Commission on these issues in 2008 to initiate this process and gather further input from companies based in different EU markets³⁸.

Concerning UCITS asset safekeeping functions, some initial principles were proposed by the Eurofi working group in addition to the proposals mentioned above.:

- Delegation of processing functions should be allowed to sub-custodians and sub-global custodians provided a) that adequate controls are in place and b) provided that sub-global custodian follows the rules of the home country of the fund.
- Delegation of safekeeping should not require replicating the assets or local booking provided that a) adequate controls are in place and b) sub global custodians follow the rules of the home country of the fund. The depositary should be free to choose the most appropriate set up for ensuring the control of assets, and it should be recognized that maintaining a custody system or replicating the assets is not necessary to ensure control over the assets
- Safekeeping responsibilities could be differentiated according to the different financial instruments as is the case eg in the French market (ie asset safekeeping for securities such as equities, bonds... and position keeping for OTC products, swaps, derivatives...) ³⁹
- The depositary should be responsible for any loss the management company or the investors may incur as a consequence of the depositary's non compliance with the obligations related to the performance of its function. But in the event of a default, if the depositary can demonstrate that it has exercised all the necessary controls and that the default has no direct relationship with the action of the depositary, then it should not be subject to the restitution of the assets safekept.

Progressive harmonization of regulatory reportings and tax legislations should also be considered in parallel.

3. Implementing the recommendations of the Eurofi group:

During the second semester of 2007 different actions were organized to communicate and promote these consensual recommendations made by the Eurofi group towards the Commission, CESR and MEPs, the professional associations (initial contacts with EFAMA and FEAM, to be completed with discussions with the ECSAs) and to the wider public (workshop during the Eurofi conference at the EU Parliament on 3 and 4 December).

The Eurofi working group will remain active in 2008 to prepare and launch the implementation of the proposals made.

1) Processing:

³⁸ Industry experts in the group indeed consider that the wording of some parts of articles defining eg safekeeping arrangements have led to diverging interpretations and practices in different Member States that are difficult to justify in a single market and go as far as practically preventing passporting rights in some cases. The European Commission had already acknowledged this issue to a certain extent in its Communication on the role of Depositaries (COM(2004) 207 final), section 2.2 however no conclusive initiatives have been taken.

³⁹ Feasibility to be further assessed

Discussions have been initiated with EFAMA to assess the detailed implementation conditions of some proposals made by the Eurofi group, particularly those relating to standardizing settlement deadlines and to evolutions in the practices of some EU markets to adapt them better to the handling of cross-border orders.

The Eurofi group will concentrate in the coming weeks on further evaluating the feasibility and possible implementation scenarios of 3 key actions mentioned above that require some further specification:

- Simplifying commission tracking through in particular the development of distributor codes with an appropriate level of granularity
- Optimizing data management at the EU level: with a possible automated process to support the future notification process and to ensure that reliable prospectus and processing data⁴⁰ is more easily available to third-party and cross-border industry players and maintained more efficiently.
- Implementing market-wide incentives to accelerate the investment in automated and standardized order routing solutions. Contacts will be made with the main industry associations concerned to test the feasibility of this proposal.

The objective of Eurofi is to clarify the feasibility and implementation scenarios of these recommendations during the first semester of 2008 and to build momentum in the market around the actions that present most technical and political feasibility and impact.

The Eurofi working group will also draft a proposed reporting template for measuring the progress of automation and standardization in cross-border fund processing and test it with the different representative associations. It will also further test the idea of setting up a permanent forum to monitor the progress of cross-border fund processing automation and standardization over time with the different representative associations.

2) Depositary and fund administration:

Eurofi met with the Commission and MEPs member of the Econ committee in November to suggest modifying certain articles of the UCITS directive at the occasion of its 2008 review, in line with the recommendations of the report, and to suggest launching a Lamfalussy-style process to define the safekeeping responsibilities of depositaries more precisely.

The Eurofi group will complete its proposals in the coming weeks.

3) Distribution:

Eurofi will re-assess during Q1 of 2008 the interest for continuing action on this topic with its steering committee following the outcome of the 4th December workshop (at the Eurofi annual conference), progress made on the competing products issue (particularly in relationship with the call for evidence of the Commission) and preliminary feedbacks from the implementation of MiFID.

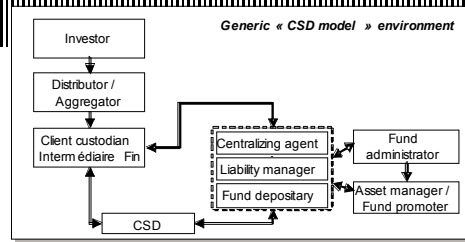
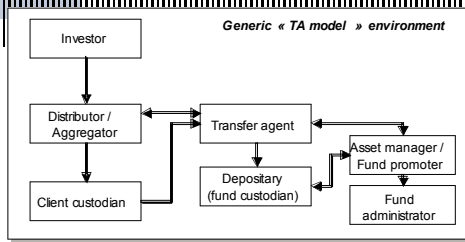
Eurofi contact: Marc Truchet, senior fellow consultant :marc.truchet@icme.com

APPENDIX :

⁴⁰ FPP Fund Processing Passport data in particular

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Main characteristics of the "CSD model" and "TA model" processing organizations



Main EU countries:

✗ Luxembourg, UK, Ireland, Italy, Spain, Belgium, Greece

Main present characteristics

- ✗ **Direct relationship between players for all layers of the entire processing chain** (distributors and institutional investors have nominal accounts with the TA in many cases):
 - ✗ enabling to handle orders originating from a variety of investors, regardless of status and location (e.g. cross-border, retail, etc...)
 - ✗ allowing TAs to identify the distributor and support the calculation of trailer fees
- ✗ **No simultaneous transfer of cash and securities**, which requires reconciliations. Potential credit and market risks usually mitigated through contractual settlement agreements or through pre-funded settlement
- ✗ TAs / cash agents can handle several settlement currencies

Main EU countries:

France, Germany, Austria, Denmark, Norway, Portugal

Main present characteristics

- ✗ **Funds are deposited within the CSD** and dematerialised or in global note form
- ✗ **Orders are mostly processed through intermediaries** who are members of the CSD (2).
- ✗ Distributors and institutional investors have an account with the intermediary
- ✗ **DVP settlement** bringing security for investors and fund promoters in domestic market
- ✗ **Centralized and standardized processing of settlement**: Position keeping function to be developed to facilitate the calculation of trailer fees in particular (does not exist at present)
- ✗ CSDs settle in their home currency only

(1) client custodian or intermédiaire financier

(2) membership is usually limited to domestic participants; membership exist

requiring certain eligibility criteria; in some cases remote

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Depositaries are appointed by the management company and have two main generic functions: oversight and asset safekeeping

The way these functions are discharged varies to a certain extent across EU countries

In most countries the depositary is appointed by the management company (1).

The depositary exercises two main functions: oversight and asset safekeeping (2)

A depositary's liability is unaffected by the fact that it has entrusted to a third party all or some assets in its safekeeping

The contents of the oversight function varies to a certain extent across countries, but generic responsibilities are the same:

- Statutory monitoring and control function of the management company (3)
- Investment compliance function
- Regular certification of the list of assets of the fund

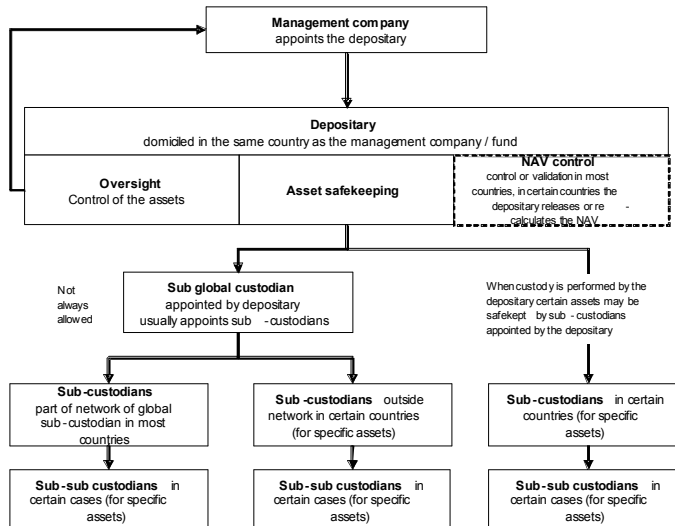
Control of the assets varies (e.g. in certain countries the depositary releases or recalculates the NAV...)

Investment restriction controls and investment compliance vary also

The asset safekeeping involves safekeeping the underlying assets in which the fund is invested. The way this function is discharged varies

Custody activities involve:

- Holding the fund cash account, collecting fund income and reconciling cash "collection accounts" with the TA, handling corporate actions



(1) The depositary is often part of the same group as the management company. In the UK the depositary is called a trustee and only performs the oversight function.

(2) Defined in the UCITS Directive

(3) Checking asset allocation, settlement of transactions, stock lending & borrowing by the management company...