

Is the UCITS
Management
Company
Passport going
places?

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IS THE UCITS MANAGEMENT COMPANY PASSPORT GOING PLACES?

Background to the Management Company Passport

The Management Company Passport (MCP) was first introduced in Directive 2001/107/EC (the Man Co Directive). However, the MCP has failed to work to date. This failure is largely due to a lack of clarity in the wording of certain sections of the Man Co Directive. In particular, it appears to prevent remote management (i.e. management from an EU member state other than the one in which the UCITS is domiciled) of UCITS constituted as contractual funds such as common contractual funds or unit trusts (contractual funds).

Furthermore, the extent to which the passport applies to Man Cos of UCITS investment companies has not been free from doubt. In January 2005¹, the Committee of European Securities Regulators (CESR) issued Level 2 guidelines² which provided clarification on the MCP procedures contained in the Man Co Directive. These guidelines indicated that the Man Co Directive does not provide for a Man Co to manage a UCITS from another EU member state (Member State). Accordingly, despite the provision for an MCP in the Man Co Directive it has not yet worked in practice.

Later in 2005, the EU Commission (the Commission) issued a consultation paper on enhancing the framework for UCITS³. This was followed in 2006 with a more detailed consultation paper which announced a set of target modifications to the UCITS Directive⁴. The areas which the Commission recommended be considered for modification were, (i) a new simplified fund passport procedure (ii) mergers of UCITS funds on a crossborder basis (iii) UCITS master/feeder structures, (iv) key investor information (to replace the simplified prospectus) (v) measures to enhance cooperation between competent authorities and (vi) the MCP.

¹ CESR's Guidelines for Supervisors regarding the Transitional Provisions of the Amending UCITS Directives (2001/107/EC and 2001/108/EC), January 2005

² Level 2 guidelines under what is known as the "Lamfalussy Process" for EU financial legislation. The Lamfalussy Process provides for four level of legislation and guidelines. Level 1 is the core principles provided for in the main Directive or Regulation. Level 2 is implementing measures (Directive or Regulations) adopted based on advice from CESR. Level 3 is consistent application of EU law through supervisory convergence. Level 4 is enforcement of timely and correct transportation of EU laws into the laws of Member States.

³ Green Paper on enhancing the European Framework for investment funds – Com (23005) 314

⁴ White Paper on enhancing the Single Market Framework for investment funds – Com (2006) 686

Following a lengthy consultation period, the Commission issued its proposals for amending the UCITS Directive on 16 July 2008. The proposals provide for the modification referred to at (i) – (v) above, but do not contain provision for a new, effective MCP. These proposals are commonly referred to as UCITS IV.

The MCP was not included in the current UCITS IV proposals because, during the consultation process, concerns were raised by a number of Member States and industry participants as to how clear allocation of responsibilities for supervision between the competent authority of the Man Co and the competent authority of the UCITS could be ensured. If this could not be ensured, it could be detrimental to investor protection and the international reputation of the UCITS brand.

In an effort to address this supervisory concern, the Commission had proposed a “partial passport” pursuant to which certain core administrative functions namely, (i) verification of valuation and pricing and (ii) maintenance of unit-holder/shareholder registers, would have to be carried out in the UCITS’ home Member State. However, the Commission recognised that its partial passport procedure had not provided a fully satisfactory solution to this issue. Consequently, it did not include provision for an updated MCP in its UCITS IV proposal. Instead, it requested CESR to provide advice which would help the Commission “to develop provisions permitting the introduction of a management company passport under conditions which are consistent with a high level of investor protection”.

Following the referral to CESR by the Commission, CESR issued a call for evidence on 17 July, 2008 (responses were received from a variety of sources including asset managers, fund administrators, law firms and industry bodies). A consultation paper containing draft advice was issued in September, 2008⁵ and an open hearing was held on 13 October, 2008. On 31 October 2008, CESR issued its advice to the Commission on the introduction of an effective MCP (CESR Advice).

Key Elements of CESR Advice

1.1 *Definition of domicile*

Man Co

⁵ Consultation Paper on UCITS Man Co Passport – September, 2008 CESR/08-748

- ▣ The Man Co's home Member State should be the Member State in which the Man Co's registered office or head office is situated.
- ▣ Authorisation of the business of Man Cos should be granted by the Man Co's competent authority. The CESR Advice sets out those conditions which must be satisfied in order for such authorisation to be granted. One of the pre-conditions for authorisation is that the Man Co must manage at least one UCITS in its home member state.
- ▣ The authorisation of the Man Co should allow the Man Co to provide services throughout the EU, either through the establishment of a branch or under the free provision of services.

UCITS

- ▣ The UCITS' home Member State for contractual funds should be the Member State in which the UCITS has received authorisation and in which the depositary of the UCITS is established.
- ▣ UCITS should be regulated in accordance with the law applicable in its home Member State and UCITS should be authorised only if the UCITS' competent authority has approved the choice of the Man Co, the fund rules and the choice of depositary.

Depositary (also known as the custodian or trustee)

- ▣ UCITS should be authorised only if the UCITS' competent authority has approved the choice of depositary, which depositary should either have its registered office in or be established in the UCITS' home Member State.
- ▣ In order to regulate the flow of information deemed necessary to allow the depositary to perform its oversight and safe-keeping functions, the depositary and the Man Co should sign a written agreement.

Local point of contact in case of contractual funds

- ▣ If the Man Co of a contractual fund is not established in the UCITS' home Member State, it should appoint the depositary or other financial institution to act as a local point of contact to perform certain functions, to include providing facilities for the receipt and transmission of orders and acting as a local information agent.

1.2 *Applicable law and allocation of responsibilities in the case of free provision of services*

In the case of the free provision of services from another Member State, the key provisions of the CESR Advice are as follows:

- ▣ Any Man Co authorised and supervised by the competent authority of another Member State providing the activity of cross border collective portfolio management through the freedom to provide services should not be subject to any additional requirements in the UCITS' home Member State except in cases referred to in the UCITS Directive.
- ▣ The Member State where the UCITS is domiciled shall regulate the constitution and functioning of the UCITS including, the rules on investment policies and restrictions, valuation of assets, relationships with investors and marketing/distribution of the units/shares.
- ▣ The Man Co should comply with the organisational measures (including risk management process and conflict of interest procedures) provided by its home Member State. However, the UCITS' competent authority should be satisfied that the Man Co's risk management process and conflict of interests policies are adequate for the UCITS which it proposes to manage. CESR further advises that the Commission should provide Level 2 guidelines on Man Co organisational measures, including risk management processes and conflict of interest procedures to ensure that these areas are harmonised in order to provide confidence between Member States and reduce the level of potential comments from the competent authority of the UCITS' home Member State.

In the case of a branch, in addition to the above, the competent authority of the Member State in which the branch is located should assume responsibility for ensuring that the services provided by the branch within its territory comply with the rules of conduct applicable in such host Member State.

CESR further provides that for the purpose of ensuring adequate supervision of the UCITS, the depositary and the Man Co, the competent authorities should have the power to conclude bi-lateral and/or multi-lateral co-operation agreements with each other. It further recommends that the Commission should provide Level 2 guidelines on the minimum standards for such co-operation agreements.

1.3 *Authorisation procedure for UCITS funds whose Man Co is established in another Member State*

- ▣ The competent authority of the UCITS' home Member State may authorise a UCITS only if it has approved the fund rules, the choice of the Man Co and the choice of the depositary. The CESR Advice sets out the circumstances in which the competent authority of the UCITS' home Member State should approve the choice of the Man Co (i.e. if the Man Co is duly authorised by its home Member State, its risk management process, conflict of interest procedures and proposed delegation arrangements are adequate and the choice does not impact the exercise of its supervisory functions).
- ▣ The CESR Advice lists the specific documents which must be provided to the UCITS' competent authority by a Man Co which applies for authorisation to set up and/or manage UCITS established in another Member State and the circumstances in which additional information may be required. These documents include (i) a report on risk management, accounting and other internal procedures (ii) a description of the relationship between the Man Co and the UCITS' depositary (iii) information on any delegation arrangements (iv) information on dealing with conflicts of interest (v) details of the local point of contact and (vi) details of how the Man Co will ensure compliance with the requirements of the competent authority of the UCITS.
- ▣ The Man Co's home Member State should provide an Attestation to the competent authority of the UCITS certifying that the Man Co fulfils the conditions imposed by the UCITS Directive and that organisational arrangements, systems and controls in place in the Man Co's home Member State are adequate for the type of UCITS which it intends to manage.
- ▣ In the event that a Man Co has seriously and/or systematically infringed the provisions adopted pursuant to the UCITS Directive, the UCITS' competent authority should have the power to refuse or withdraw the approval of the choice of Man Co.

CESR further recommends that the Commission should establish implementing rules designed to detail the procedure for (i) the authorisation of the UCITS, (ii) the approval of the choice of a Man Co authorised in another Member State by the UCITS' competent authority and (iii) to deal with cases in which disagreements occur between competent authorities, including determining whether mediation may be necessary.

1.4 *On-going supervision of the management of the Fund*

- ▣ The competent authority of the Man Co should receive the reports on the management activity performed through branches or through freedom to provide services as required by the legislation of the Member State.
- ▣ The UCITS' competent authority should receive the reports which the UCITS must provide under the law applicable to it. The competent authority of the Man Co must also have access to these reports.
- ▣ The Commission should provide Level 2 guidelines on setting up databases which will enable competent authorities to share information which could reduce the reporting burden on the UCITS and the Man Co.
- ▣ The competent authority of the UCITS should be able to request the co-operation of the Man Co's competent authority for on site verifications or investigations of the Man Co to the extent that it is necessary with respect to the supervision of the UCITS.
- ▣ The Man Co's competent authority should be able to request the co-operation of the competent authority of the UCITS and its depositary for on site verifications or investigations of the depositary to the extent it is necessary with respect to the supervision of UCITS.
- ▣ In the event that the UCITS and the Man Co have different auditors, their respective auditors should enter into an information-sharing agreement in order to ensure the fulfilment of the duties of both auditors. The Commission should provide Level 2 guidelines on the minimum content which should be included in such agreements.

1.5 *Dealing with breaches of rules governing the management of the Fund*

- ▣ The UCITS' competent authority should be able to directly impose administrative sanctions and measures on any Man Co providing services either through the freedom to provide services or a branch for violation of the rules which fall within its remit provided such sanctions are effective, proportionate and dissuasive.
- ▣ If such sanctions are to be imposed upon Man Cos located in other Member States, the UCITS' competent authority should inform the Man Co's competent authority. The Man Co's competent authority may make representation to the UCITS' competent authority in relation to the type of measure and level of the sanctions.

- ▣ The Man Co's competent authority should have the power to serve the legal documents which are necessary to enforce the sanctions or measures taken by the UCITS' competent authority against the Man Co.
- ▣ As a last resort, if the conditions under which the choice of Man Co was approved are no longer fulfilled and the interests of unit-holders/shareholders are prejudiced the UCITS' competent authority may withdraw the approval of the choice of Man Co.
- ▣ Claims against a UCITS and the Man Co in relation to the management of a UCITS should be lodged by investors in a court in the UCITS' home Member State in accordance with the law applicable to the UCITS.
- ▣ Member States should promote the setting up or development of efficient out-of-court complaints and redress procedures for the settlement of investor disputes concerning the management of UCITS.

Analysis of the CESR Advice

In general, Member States and industry participants agree with the principle of taking further steps towards EU single market integration and achieving increased efficiencies, provided the integrity of the UCITS brand can be maintained. However, there still appears to be questions over how this can be best achieved.

The CESR Advice itself was not supported by five Member States (Ireland, Luxembourg, Poland, the Slovak Republic and Slovenia) as they remained concerned that the proposed supervisory framework would be difficult to operate effectively in practice. Indeed, a number of other Member States approved the general principles of the CESR Advice but expressed reservation about certain aspects of it including the complexity of the proposed MCP framework. CESR itself has recommended that Level 2 guidelines are necessary in order to allow the smooth introduction of the MCP framework.

The domicile of a UCITS is an important question not just from a legal perspective (which is considered in the CESR Advice as outlined above), but also from a tax perspective. A clarifying amendment to the definition of domicile in the UCITS Directive would not necessarily be sufficient to satisfy tax authorities in various jurisdictions that their criteria for domicile are satisfied.

As is evident from the above, the CESR Advice has not been unanimously supported and will require substantial level 2 guidelines to enable it to work. We therefore await the Commission's response to the CESR Advice to see if it deems it viable or if more work will be required to achieve a workable MCP.

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