

**OPINION OF THE EUROPEAN CENTRAL BANK**

**of 16 March 1999**

**at the request of the Council of the European Union under Articles 109l(2) and 109f(6) of the Treaty establishing the European Community and Article 5.3 of the Statute of the European Monetary Institute on two European Commission proposals for European Parliament and Council Directives amending Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), ref. 98/0242 — COM(1998) 451 final and ref. 98/0243 — COM(1998) 449 final**

(CON/98/54)

(1999/C 285/08)

1. The European Central Bank (hereinafter referred to as the 'ECB') received requests from the Council of the European Union (hereinafter referred to as the 'Council'), dated 16 and 26 October 1998, for an ECB opinion on draft legislative proposals for European Parliament and Council Directives (hereinafter referred to as the 'draft Directives') amending Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (hereinafter referred to as the 'UCITS Directive').
 

new version of the UCITS Directive would be preferable. This is all the more the case since the UCITS Directive appears to have been interpreted differently by Member States. Such different interpretations are undesirable in the context of a single money and financial market and may lead to competitive distortions and misallocation of funds. Alternatively, consideration could be given to the possibility of including a new recital (introduced by 'whereas') in both draft Directives stating that all Member States should make every effort to implement both Directives simultaneously in their national legislation.
2. In accordance with Article 109l(2) of the Treaty establishing the European Community (hereinafter referred to as the 'Treaty'), the ECB has taken over the advisory functions of the European Monetary Institute (EMI), which went into liquidation upon the establishment of the ECB on 1 June 1998. The requests from the Council were based on Articles 109l(2) and 109f(6) of the Treaty. The ECB's competence to deliver an opinion is now based on Article 105(4) of the Treaty and Article 4(a) of the Statute of the European System of Central Banks and of the European Central Bank, both of which entered into force on 1 January 1999. In accordance with Article 17.5, first sentence, of the Rules of Procedure of the ECB, this ECB opinion has been adopted by the Governing Council of the ECB.
3. The ECB has decided to deliver one opinion dealing with both consultations as the two draft Directives both aim at amending Directive 85/611/EEC. The ECB understands that the Commission of the European Communities has prepared a package of measures distributed through separate proposals: the first (COM(1998) 449 final) focuses essentially on the types of investment funds, whereas the second (COM(1998) 451 final) focuses essentially on the service provider (the management company) and on the prospectus requirements for UCITS. In the explanatory memoranda to both draft Directives, it is stated that it will be of no consequence if one of the two Directives is adopted more rapidly than the other. However, given the fact that amendments to one draft Directive may have an impact on the other and the fact that the draft Directives propose substantial modifications to the UCITS Directive, the ECB believes that, for the sake of clarity, transparency and legal certainty, discussion of a complete and integral
4. The ECB notes that the draft Directives present a new solution to issues dealt with, in part, in an earlier proposal for a Directive amending the UCITS Directive (COM(93) 37 final, modified by COM(94) 329 final) on which the EMI delivered an opinion on 27 July 1995 (CON/94/8). The ECB notes that, to a certain extent, the draft Directives raise issues similar to those contained in the earlier proposal. Consideration may therefore also be given to the advisability of taking account of the previous opinion of the EMI in the context of the discussion on the draft Directives.
5. The ECB notes that any amendment to Directive 85/611/EEC might have an impact on the legal definition of money market funds for statistical purposes, as defined by the ECB itself in Annex 1, Part I, Section I, paragraphs 5 and 6 of the ECB Regulation concerning the consolidated balance sheet of the Monetary Financial Institutions sector (ECB/1998/16), as adopted by the Governing Council of the ECB on 1 December 1998 (OJ L 356, 30 December 1998, p. 7). Therefore, the draft Directives have been assessed in particular with regard to their consistency with the ECB's legal definition of money market funds.

**I. COM(1998) 449 final**

1. One objective of this draft Directive is to remove barriers to the cross-border marketing of units of collective investment undertakings through (a) the extension of the freedom to be marketed throughout the European Union

- to collective investment undertakings investing in financial assets other than transferable securities, such as units of other collective investment undertakings, money market instruments, bank deposits, standardised options and futures contracts, (b) the revision of some provisions in order to update the UCITS Directive in the light of new portfolio management techniques which have been developed since 1985 and (c) the removal of uncertainties relating to the interpretation of a number of provisions contained in the UCITS Directive which impede uniform application of the Directive.
2. The ECB takes note of the objectives of the draft Directive, in particular the extension of the definition of UCITS to those collective investment undertakings investing in financial assets other than transferable securities, such as units of other collective investment undertakings, money market instruments, bank deposits, standardised options and futures contracts, because the definition of the existing UCITS Directive does not cover all money market funds, some of which also invest in bank deposits in some countries. In addition, definitions of transferable securities and money market instruments are provided in the draft Directive, both of which are broadly in line with the definition used by the ECB for statistical purposes.
  3. The ECB notes that Article 1(7) of the draft Directive proposes a new Article 22(a) of the UCITS Directive facilitating the establishment of UCITS, the investment policy of which is to 'replicate' a specified stock index. The Council may wish to consider whether it may be preferable to refer to UCITS, the investment policy of which is to 'track' a specified stock index. In this case the kind of 'tracking' would have to be specified in order to ensure uniform application of the respective provisions. The ECB recognises that there is an interest in the establishment of such types of UCITS. Nevertheless, the ECB recommends that the provision of Article 22(a)(2) (definition of replicate stock indices) be spelt out in greater detail so as to ensure that no distortions arise as a result of certain existing indices not being on the list published by the European Commission, recognising however the technical difficulties of establishing more detailed notions. In particular, the notions of 'having a composition which is sufficiently diversified', 'being easy to replicate' and 'representing an adequate benchmark for the equity market to which they refer' are not sufficiently clear, which may result in unwarranted market distortions, if certain indices were to be unduly promoted more than other indices. Furthermore, consideration might be given to whether the limit of 35 % in Article 22(a)(1) is too high. The investment of up to 35 % of the assets of a fund in instruments of one issuer can hardly be reconciled with the principle of risk-spreading laid down in Article 1(2) of the existing UCITS Directive which shall apply to all UCITS.
  4. The ECB notes that the scope of the definition of UCITS (Article 1(1) of the draft Directive, amending Article 1, paragraph 2, first indent of the UCITS Directive) has also been extended to cover money market funds and is consistent with the ECB's legal definition of money market funds. The ECB notes in particular that Article 1(3) of the draft Directive (proposed new Article 19, paragraph 1(f) of the UCITS Directive) provides for the possibility of investing in 'deposits with credit institutions'. In this context, the ECB notes that Article 1(9) of the draft Directive allows for investments of up to a maximum of 35 % of the UCITS assets in deposits with credit institutions of the same group. In this respect, the ECB should like to draw attention to the EMI opinion (CON/94/8). Under the current proposal in the draft Directive, an investor could lose up to 35 % of his/her investment through the failure of a single credit institution. The considerations concerning appropriate warnings to investors also apply in the context of this proposal (see below). In this respect, the Council may wish to consider lowering the maximum limit for investment of the UCITS assets in deposits with credit institutions of the same group. In this context it also seems questionable whether the investment of up to 35 % of the assets of a fund in instruments of one issuer can be reconciled with the principle of risk-spreading laid down in Article 1(2) of the existing UCITS Directive which shall apply to all UCITS. Moreover, when defining the relevant limits the Council may wish to take into account the fact that a fund may incur exposure to the same credit institution also in relation to instruments and contracts other than 'deposits' (e.g. debt securities, equities or OTC derivative contracts).
  5. The ECB welcomes the fact that the definition of transferable securities, as determined by Article 1(2) of the draft Directive (proposed new Article 1, paragraph 8(a) of the UCITS Directive), is consistent with the definition of negotiable instruments used by the ECB for statistical purposes.
  6. The ECB notes that the definition of money market instruments, which is provided in Article 1(2) of the draft Directive (proposed new Article 1 paragraph 8(b) of the UCITS Directive) and further specified in Article 1(3) of the draft Directive (proposed new Article 19, paragraph 1(i), of the UCITS Directive) is broader in scope than that contained in the ECB's legal definition of money market funds but is consistent with the ECB's definition in general terms. The latter is more specific in defining the requirements for a financial instrument to be considered as a money market instrument, such as liquidity, depth of the money market and certainty in value and low interest rate risk. The ECB notes that this could result in a financial instrument representing a money market instrument according to Community law failing to

fulfil all criteria as determined in the ECB's legal definition of money market funds. This becomes obvious on considering the ECB's legal definition of money market funds contained in Annex 1, Part I, Section I, paragraph 6(iv) to the ECB Regulation concerning the consolidated balance sheet of the Monetary Financial Institutions sector (ECB/1998/16), which defines low interest rate risk *'in the meaning of having a residual maturity of up to and including one year, or regular yield adjustments in line with money market conditions at least every twelve months'*. As the definition given in the draft Directive is broader than the ECB's definition and as the draft Directive is not aimed at defining categories of UCITS, the two definitions do not seem to be in contradiction. Nevertheless, the ECB notes that a harmonisation of the definitions would promote transparency.

7. In addition, the ECB considers that the possibility for UCITS, as laid down in Article 1(3) of the draft Directive (proposed new Article 19, paragraph 1(f) of the UCITS Directive) of also investing in 'deposits with credit institutions' is consistent with the ECB's legal definition of money market funds. The latter determines more precisely the kind of bank deposits in which a money market fund may invest in order to be considered as such. However, as no distinction is made in Community law between different categories of collective investment institutions, this does not give rise to any inconsistencies. Nevertheless, the ECB notes that a harmonisation of the definitions could be considered.
8. Given the fact that amendments to the UCITS Directive might have an impact on the ECB's legal definition of money market funds, the ECB suggests that the relationship between the UCITS Directive and the ECB's legal definition of money market funds should be clarified in a recital (introduced by 'whereas') in the draft Directive by referring to the competence of the ECB to define money market funds within the framework of the ECB Regulation concerning the consolidated balance sheet of the Monetary Financial Institutions sector.
9. The ECB believes that careful consideration should be given to measures safeguarding the transparency and stability of UCITS. In this respect, the ECB holds the view that careful consideration should be given to the appropriateness, desirability and feasibility of measures safeguarding the principle of risk-spreading. In this context, the Council may wish to consider whether it is advisable, in respect of the calculation of thresholds for the investment in transferable securities and/or instruments of a single issuer, for 'connected' issuers to be regarded as a single risk as a matter of principle. The draft Directive introduces this principle in relation to investments in deposits with credit institutions (Article 1(9) of the draft Directive, introducing a new Article 24(a) of the UCITS Directive), but this principle could apply irrespective of the type of investment or instrument. The ECB recognises, however, that the requirement that 'connected' issuers have to be regarded as a single risk could impose additional burdens on the management companies. Therefore, a qualitative approach could be considered, possibly as a transitional solution only, whereby the UCITS manager would be required to ensure that, taking account of the objective of the scheme and the manager's policy for achieving that objective, as stated in the most recent fund rules or instruments of incorporation, the scheme provides a prudent distribution of issuer risk considering all investments and instruments. In relation to this alternative solution the Council may wish to consider the possible potential for supervisory arbitrage.
10. The ECB recommends that a review is made of a potential inconsistency between the possibility for more traditional UCITS of investing in derivatives for hedging and portfolio management purposes and the rules on the investment policy of derivatives-specialised UCITS, namely in relation to the OTC market (to which only the former category may resort). The Council may wish to consider whether the use of OTC derivatives should be allowed for all types of funds under the same conditions. The relationship between Article 21 of the Directive and the new Article 24a may need to be clarified. Furthermore, the ECB recommends reconsideration of the fact that the draft Directive does not establish any specific limits or other more specific measures to protect investors against risks related to derivative transactions.
11. The ECB notes that the draft Directive contains a number of provisions which determine specific obligations concerning the 'prospectuses and any promotional literature' (see Article 1(9) of the draft Directive proposing a new Article 24(a) of the UCITS Directive) and which deal with obligations concerning the investment policies of UCITS. The inclusion of these provisions is not systematic and transparent and may lead to conflicting solutions. The Council may wish to consider combining all obligations concerning the mandatory information to be given to investors in one section of the UCITS Directive. In this context, the ECB wishes to recall the EMI's suggestion, as made in the EMI opinion mentioned above (CON/94/8), that consideration should be given to the imposition of an obligation in the UCITS Directive stating that the investors should be informed that funds which constitute close substitutes for deposits (money market funds/cash funds) will not be subject to deposit protection.
12. With the aim of reinforcing the soundness and transparency of the regulation of these financial instruments, the ECB underlines the need that UCITS should invest, as a general rule, only in other 'coordinated' investment funds. Investments in non-coordinated funds could be possible subject to further suitable strict safeguards protecting the position of the investors.

13. Respecting the importance of the control function of the depositary and the necessary strength of the regulation of UCITS, the Council may wish to reconsider the provisions restricting or prohibiting transactions with the UCITS' depositary (Article 1(6) and 1(9) of the draft Directive). These provisions may be inconsistent with commercial practice and, instead of being prohibited, could be made subject to the requirement of being carried out under normal commercial terms. Similarly, the requirement concerning the location of subsidiaries might be drafted in a more flexible way. Subsidiaries outside the EEA could be accepted subject to the necessary conditions relating to efficient supervision of at least the same level of quality as in the EEA. However, it is stated in this context that the national central banks hold divergent views on these proposals and in some cases are even of the opinion that none of the proposals is feasible.

## II. COM(1998) 451 final

1. The ECB notes that the aim of this draft Directive is to reinforce the single market in the area of UCITS by: (a) updating the rules governing management companies by bringing these into line with those existing for other operators in the financial services area (banks, investment firms and insurance companies), in consideration of the ongoing growth of this sector (in particular, these operators would receive a 'European passport' that, in accordance with the principles of the Treaty, would allow them to set up branches in other Member States and to operate within the EU with the freedom to provide services); (b) revising the current restrictions which prevent management companies from engaging in activities other than the management of the assets of common funds/unit trusts investment companies (collective portfolio management); (c) identifying the functions which the activity of collective portfolio management comprises; (d) defining the conditions under which such functions can be delegated to third parties; and (e) amending the provisions concerning the information documents to be given to investors (in this respect the proposal introduces simplified procedures).

2. The ECB notes in particular that the draft Directive aims at widening the scope of the business of 'management companies'. This widening and the expansion of the product range as well as the granting of the 'European passport' as proposed in the draft Directive may substantially contribute to a further process of desintermediation of financial services, in the sense that more and more financial intermediation will be carried out via institutional investors rather than via credit institutions. As stated in the EMI opinion (CON/94/8), this may contribute to significant changes in the business environment and liability structure of credit institutions. Care should therefore be taken to ensure that the proposed prudential supervisory regime meets the standards necessary to foster financial stability and will result in a consistent prudential framework for all financial intermediaries, which takes account of their specific features.

3. The ECB notes that the draft Directive proposes that the specialisation principle applied to date in the area of UCITS be rendered more flexible. According to the draft Directive, there will be two distinct types of 'management companies': those which exclusively engage in the management of unit trusts/common funds and investment companies and those which also provide 'discretionary portfolio management'. For the latter category, the draft Directive (Article 1(3) of the draft Directive proposing a new Article 5.4 of the UCITS Directive) suggests the application of certain Articles of Directive 93/22/EEC. According to the draft Directive, the ECB understands that UCITS may be managed or 'constituted' by three different types of enterprises to which three different sets of rules would apply: 'investment companies', 'management companies' and 'management companies, the authorisation of which covers the discretionary portfolio management service'. The ECB believes that there might be a certain risk of supervisory arbitrage and confusion induced by this relatively complicated structure. In particular, this may be the case whenever the investment companies outsource their management activities to other enterprises. The Council may wish to consider different possible solutions on which the national central banks hold divergent views and in some cases are even of the opinion that none of the proposals is feasible. First, whether a complete integration of the UCITS business into the scope and application of Directive 93/22/EEC might not be preferable and whether this would provide for the equal and consistent application of the supervisory standards elaborated for investment firms, thus better ensuring the stability of the financial system. Second, the proposed structure could be simplified by (a) removing the restriction on the activities of management companies in the UCITS Directive, or (b) allowing the credit institutions, investment firms and insurance companies authorised under the relevant single market Directives to manage the assets of UCITS as well as individual portfolios by extension of the Investment Services Directive and the Second Banking Directive. Third, the scope of the proposed new Article 5(g) of the UCITS Directive (which deals exclusively with management companies) may be enlarged to also cover investment companies, and to the foreseen requirements a further requirement could be added stating that the mandate may be conferred only upon credit institutions and investment firms authorised under the relevant single market Directives and upon similar third country institutions that are subject to equivalent prudential requirements. Whichever solution may be developed, the objective of avoiding conflicts of interest should be pursued. Moreover, the ECB would like to stress the importance of equivalent prudential rules being applicable to the different intermediaries.

4. The ECB notes that the draft Directive proposes certain cooperation obligations for 'competent authorities'. The ECB welcomes the respective provisions and would like to suggest that the Council considers even broader cooperation obligations which would also include cooperation with authorities competent in the supervision of insurance undertakings, since such undertakings often own subsidiaries active in the UCITS business.

5. Article 1(3) of the draft Directive (proposed new Article 5 of the UCITS Directive) provides that management companies shall be granted an official authorisation by the competent authorities in the home Member States and that such authorisation shall be valid in all Member States. This provision has a direct impact on the List of Monetary Financial Institutions, in so far as management companies managing money market funds will be able to operate through branches which are established in other Member States. With respect to the activities of the European System of Central Banks (hereinafter referred to as the 'ESCB'), the ECB notes that this provision has the effect that the national central bank of the Member State in which such branches are located will have to report the branches as domestic Monetary Financial Institutions and include the reference and residence of the head office, as is currently the case for credit institutions.
6. Article 1(3) of the draft Directive (proposed new Article 6(c) of the UCITS Directive) provides that the host Member State may, for statistical purposes, require all management companies with branches within its territory to report periodically on their activities to the competent national authority in that host Member State. With respect to the activities of the ESCB, the ECB notes that this provision does not prejudice the collection of additional statistical information in accordance with Article 5 of the Statute of the European System of Central Banks and of the European Central Bank.
7. Article 1(5) of the draft Directive (proposed new Article 27, paragraph 1, and Article 28, paragraph 1 of the UCITS Directive) provides for simplified prospectus requirements. According to these draft provisions, only the distribution of a simplified prospectus is mandatory, whereas the full prospectus shall be provided, free of charge, at the investor's request. The elements to be contained in the simplified prospectus are outlined in Schedule C annexed to the draft Directive. With respect to the ECB's legal definition of money market funds, the ECB notes that the ECB's definition in Annex 1, Part I, Section I, paragraph 5 to the ECB Regulation concerning the consolidated balance sheet of the Monetary Financial Institutions sector (ECB/1998/16) states that 'the criteria identifying a money market fund may be derived from the public prospectus, fund rules, instruments of incorporation, established statutes or by-laws, subscription documents or investment contracts, marketing documents, or any other statement with similar effect, of the collective investment undertakings'. This provision implies that even a full prospectus may not be sufficiently detailed in every case. The ECB notes that the introduction of a simplified prospectus, in addition to the full prospectus, does not change the existing situation, as Schedule C of the draft Directive foresees under 'Investment Information' a rather general definition of the objectives, investment policy and historical performance of the UCITS and the profile of the typical investors for which they are designed. The ECB states that this general definition may not be sufficiently detailed to provide a basis for the inclusion or exclusion of the various UCITS in or from the list of Monetary Financial Institutions. Therefore, consideration may need to be given to amending the definition accordingly.
8. As already outlined under Article I.8., the ECB suggests that the relationship between the UCITS Directive and the legal definition of money market funds set out in the ECB Regulation concerning the consolidated balance sheet of the Monetary Financial Institutions (ECB/1998/16) should be clarified in a recital (introduced by 'whereas') to the draft Directive.
9. The Council may wish to consider a significant increase of the initial capital required in the proposed new Article 5(a)(1)(a) of the UCITS Directive. The amount of EUR 50 000 <sup>(1)</sup> does not seem to be an adequate capital base for the activities allowed.

This ECB opinion will be published in the *Official Journal of the European Communities*.

Done at Frankfurt am Main, 16 March 1999.

*The President of the ECB*

Willem F. DUISENBERG

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<sup>(1)</sup> The ECB assumes that all references to ECU will be replaced by references to the euro.