OPINION OF THE EUROPEAN MONETARY INSTITUTE

on a Consultation received from Danmarks Nationalbank under Article 109f(6) of the Treaty establishing the European Community and Article 5.3 of the Statute of the EMI on a proposed law concerning UCITS and NON-UCITS ("Forslag til lov om investeringsforeninger og specialforeninger").

CON/96/12

1. The present consultation was initiated by a letter from Danmarks Nationalbank dated 15 August 1996, enclosing a proposed draft law concerning UCITS and NON-UCITS in the Danish language ("Forslag til lov om investeringsforeninger og specialforeninger") ("the Bill") and a set of explanatory comments in respect of the provisions of the Bill, also submitted in the Danish language ("Bemærkninger til lovforslagets enkelte bestemmelser") ("the Explanatory Comments"). Danmarks Nationalbank has also submitted a brief explanatory memorandum in Danish (on 20 August 1996) and in translation to English (on 22 August 1996) ("the Memorandum").

2. The main purpose of the Bill is to extend the present Danish legislation concerning investment funds, which is based upon the European Directive on Undertakings in Collective Investment in Transferable Securities (UCITS) (85/611/EEC) ("the UCITS Directive"), to encompass new forms of funds labelled specialised investment funds, and referred to in the Memorandum as NON-UCITS. One objective of the new specialised investment funds is to improve opportunities to provide capital to small and medium-sized enterprises; it is also proposed that so-called money market funds ("pengemarkedsforeninger") be permitted in Denmark.

3. As background to the proposed extension of the existing Danish law on investment funds to include also specialised investment funds, the Explanatory Comments refer to the proposal for a European Parliament and Council Directive amending the UCITS Directive[1] ("the Proposed Amendment Directive"). However, the Proposed Amendment Directive, which inter alia suggested a broadening of the UCITS Directive to include four new categories of investment

[1] Commission proposal for a European Parliament and Council Directive amending Directive 85/611/EEC, OJ No. C 59, 2 March 1993, p. 14, as amended by OJ No. C 242, 30 August 1994, p. 5.

funds (money market funds, cash funds, funds investing in units of other UCITS, so-called funds-of-funds, and master/feeder funds), has not yet been adopted. The Explanatory Comments also note that a number of the Member States of the European Union have provided for other categories of investment funds in their domestic legislation as a supplement to Community legislation on UCITS. In view of the above and the competitive situation for investment products, the Bill proposes four new specialised investment funds:

(a) “Placement funds” (“placeringsforeninger”);

(b) Money market funds (“pengemarkedsforeninger”);

(c) Investment institute funds or funds-of-funds (“investeringsinstitutforeninger”); and

(d) “Business development funds” (“erhvervsudviklingsforeninger”).

4. The EMI is competent to deliver an opinion in this consultation on the basis of Article 109f(6) of the Treaty, Article 5.3 of the EMI Statute and Article 1.1, fifth indent, Council Decision 93/717/EC of 22 November 1993 for the following reasons. Firstly, the introduction of these new specialised investment funds (also referred to below as “NON-UCITS”) would affect the stability of financial institutions and markets and, secondly, the Bill is not merely a measure to implement Community legislation since the scope of the proposed Bill goes beyond the scope of the existing UCITS Directive. The scope of the Bill also goes beyond that which is covered by the Proposed Amendment Directive, which latter Directive has not been adopted. In this connection, the EMI recalls its opinion on the consultation from the Council of the European Communities in respect of the Proposed Amendment Directive (CON/94/8), including its dissenting opinions.

5. There are three general aspects of the proposed Bill which the EMI wishes to highlight: (i) the impact of money market funds on financial markets, notably on the financing of credit institutions; (ii) the stability of the new specialised investment funds themselves; and (iii) the distinction between UCITS and NON-UCITS and the concern that potential problems arising in respect of NON-UCITS could negatively affect the existing UCITS regime.

5.1 When it comes to **the impact of money market funds on financial markets**, it should be duly noted that a wide acceptance of money market funds may lead to changes in the liability structure of credit institutions. Retail deposits which are inexpensive and, in general, relatively stable would be replaced by whole-sale deposits made on behalf of investment funds. Taken as a whole, these deposits will be less stable and more expensive for the banks that hold these deposits than equivalent retail deposits and this could exert further pressure on credit institutions' interest rate margins. The EMI notes that the Danish legislator has duly considered these aspects and concluded that the introduction of money market funds will not pose a threat to the stability of the Danish banking system in the light of the specific features of Danish markets (e.g. the high degree of competition in the deposit market, a large secondary bond market and the applicable fiscal regime with no tax advantages related to investments in money market funds).

The EMI would also suggest that the Danish legislator considers imposing an obligation to inform the investor that his investment in a money market fund will not be subject to deposit protection. Such an obligation appears desirable as the units in these funds are likely to be sold as substitutes for bank deposits. Although the principle of risk spreading will reduce the risk of total loss to an investor, the provision of appropriate information to investors to enable the proper assessment of the risks represented by particular classes of investments is essential for the stability and maintenance of trust in the financial markets (which concern would extend not only to money market funds, but also to the proposed new placement funds, funds-of-funds and business development funds).

5.2 The risk of loss for investors would also relate to the question of **the stability of the specialised investment funds themselves.** The EMI welcomes the proposals that the establishment in Denmark of any such funds would need the prior approval by the Danish Financial Supervisory Authority ("Finanstilsynet") (Chapter 2 of the Bill) and that also NON-UCITS would be subject to the Danish supervisory regime (Chapter 13 of the Bill).

The EMI also notes that the maximum placement through investments in securities issued by the same issuer and related rules differ for NON-UCITS in comparison with UCITS (as summarised for the four proposed new NON-UCITS in the Memorandum provided by Danmarks Nationalbank), and that the risk-spreading requirements for NON-UCITS will be less demanding than the existing requirements for UCITS. By way of example, the Bill suggests that the proposed placement funds, which would be allowed to invest in the same type of securities as existing UCITS, should be allowed to place a maximum of 30% of their respective capital in certain categories of securities issued by the same issuer, which limit may be compared with the existing 5% for UCITS (which latter level, however, can be raised by a Member State to a maximum of 10% under certain conditions, cf Article 22 of the UCITS Directive). Similarly, the corresponding limits for money market funds and funds-of-funds are also higher than for existing UCITS. These provisions will permit a significant concentration of risk, having the potential to impact on the stability of the funds in question which could possibly affect the stability of financial markets. These considerations add further weight to the inclusion of adequate information to investors referred to above.

5.3 The EMI would also suggest that **the new NON-UCITS are clearly distinguished from UCITS.** The Bill proposes to cover both UCITS and NON-UCITS and it is important that these two categories of investment funds are nevertheless clearly identified in the Bill as falling under two different regulatory and legal structures, and that only UCITS are covered by the more strict legal regime set out in the UCITS Directive. The EMI notes that the distinction between UCITS and NON-UCITS is presently addressed in inter alia Section 3, third paragraph and Section 4, first paragraph, of the Bill. However, the Bill could also provide that the prospectus requirements in respect of the various funds should set out the need to inform investors of this distinction and to what category the fund in question belongs (cf Section 5, second paragraph and Chapter 6 of the Bill). In this connection, the EMI notes and welcomes the remarks in the Explanatory Comments, page 15, where it is stated that the rules to be issued by the Financial Supervisory Authority under Section 35, second paragraph, of the Bill will provide such prospectus requirements.

6. The EMI has no objection to this opinion being made public.

10th October 1996