ICI Global Position Paper on Delegation in the Context of the European Commission’s Proposed Reform of the European Supervisory Authorities
Dated 23 January 2018

I. Overview and Executive Summary

ICI Global¹ is deeply concerned that Article 31a on third-country delegation in the European Commission’s (Commission) proposed reforms of the European Supervisory Authorities (ESAs) will detrimentally affect the prominence of UCITS as global investment vehicles.² Many of our members manage and sponsor regulated funds domiciled in multiple jurisdictions (including UCITS) and have global business operations that provide services to those funds. The Commission’s proposed Article 31a has the potential to affect directly these firms that currently service UCITS worldwide for the benefit of EU³ and global investors.

The Commission’s proposal would enable the European Securities and Markets Authority (ESMA) to review and potentially override Member States’ authorisation of a UCITS fund manager that delegates a material part of its activities to delegates in non-EU countries while maintaining the status quo for authorisation of delegation to other EU Member States. This bifurcated approach—which calls into question delegation outside the European Union—risks raising costs to UCITS investors by imposing unnecessary requirements and possibly severely limiting the efficient delegation of asset management functions outside the European Union. Article 31a therefore has the potential to result in significantly negative consequences for UCITS and their investors.

As explained in greater detail below, we believe EU policymakers should not adopt Article 31a for the following reasons:

- Delegation enables asset managers to bring efficiency and expertise to the operation of UCITS for the benefit of fund investors by enabling these funds to access investment expertise around

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¹ ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI’s membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US$28.6 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

² Our additional concerns with certain other aspects of the proposal are not addressed in this paper, which is focused on the provisions regarding delegation.

³ The terms “EU” and “European Union” refer to both the European Union and the European Economic Area, as applicable.
the globe in a cost-effective manner. The UCITS Directive⁴ recognizes the benefits of
delegation and provides strong oversight over this practice to protect investors.

- The proposed new provision on delegation does not add any benefits to the existing UCITS
framework because ESMA already has all the authority it needs to harmonize standards for
delegation. The Commission also fails to articulate a rationale for disparate treatment of third-
country delegation and takes ESMA on a needless detour rather than encouraging ESMA to
focus its existing powers and resources to tackle challenges that have already been identified,
such as cross-border distribution of UCITS.

- A change to the current process for approving delegation and potentially limiting a
management company’s ability to delegate portfolio management outside of the European
Union could increase investor costs, lessen the quality of the investment expertise, and/or limit
UCITS offerings. These negative consequences could lead investors to forego UCITS and
instead look to other types of collective investment vehicles or products to meet their
investment needs.

Section II of this paper illustrates the benefits that UCITS have provided and are providing not only to
EU and globally-based investors but also to EU companies and the EU economy. Section III describes
how the current regulation of delegation provides an appropriate balance of flexibility and proper
oversight. Section IV argues that the proposed delegation provision would not provide additional
benefits to the UCITS regulatory framework. Section V explains how imposing unnecessary burdens
on delegation would result in increased costs to investors and may prompt asset managers to find an
alternative vehicle to serve the needs of EU and global investors.

Given the phenomenal success of UCITS and the regulatory framework, we caution EU policymakers
against disturbing the appropriate balance of regulation and flexibility that has served EU and global
investors so well for over three decades.

II. UCITS Framework is a Global Success Story that Has Provided and Is Providing
Tremendous Benefits to Investors Globally and to the EU Economy

The growth and global reach of UCITS since their creation in 1985 have been nothing less than
remarkable. Policymakers should consider any potential changes to the UCITS framework in this
context. UCITS are the only truly cross-border investment vehicle and a premier example of a
regulatory framework that has facilitated successful European financial innovation. With more than
€9.4 trillion in total assets under management in UCITS as of end Q3 2017,⁵ policymakers should be
careful to avoid unintended negative consequences for UCITS, their investors, and the financial
markets.

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⁴ Directive 2007/16/EC, as amended. For purposes of this paper, the term “UCITS Directive” refers to the Directive as well
as relevant Level 2 and Level 3 text.

A. Significant Percentage of UCITS Assets are Owned by Investors Worldwide

UCITS are an attractive investment vehicle for both retail and institutional investors, not only in the European Union but also throughout the globe. Recognizing the potential of UCITS as an investment and savings tool for investors located throughout the world, fund sponsors began promoting UCITS outside of the European Union shortly after the establishment of the UCITS framework. The ability to invest in UCITS from jurisdictions throughout the world has grown over time, and UCITS are currently held by investors in more than 75 countries. We understand roughly 47% of assets under management in UCITS are denominated in a currency other than Euro, indicating that UCITS are widely distributed beyond the Eurozone.\(^6\) As of June 2017, an estimated €3.3 trillion in assets are managed by UCITS that are registered with at least one non-EEA regulator for distribution outside of the European Union (approximately 36% of total UCITS assets). The worldwide distribution of UCITS and the prevalence of non-EU domiciled investors makes changes to the UCITS regulatory framework globally relevant.

B. UCITS Provide Investors the Opportunity to Access a Broad Range of Domestic and Foreign Investments

A main reason for the success of UCITS is the ability to offer investors—both in the European Union and elsewhere—access to a broad range of investments within a strong regulatory framework. UCITS are able to invest across a broad range of securities (both in terms of geographic location of the issuer and the type), enabling investors to gain exposure to a variety of investments as long as they are consistent with the fund’s investment strategy. Both retail and institutional investors can invest in a wide universe of UCITS, ranging from those focused on emerging markets, US equities, or Eastern European bonds. The UCITS delegation model facilitates the breadth of UCITS offerings and allows an investor to invest in a way that meets that investor’s particular needs, within a highly regulated collective investment vehicle.

In fact, policymakers in a number of Member States have actively encouraged fund managers (particularly in Asia) to establish UCITS to provide EU and non-EU investors with access to their Asian investment expertise. This proposal could change fundamentally this type of delegation model—disrupting the operation of many of these funds and impacting investment options for investors.

C. UCITS Support Capital Formation and Job Creation in the European Union

Through their investment in EU securities, UCITS—with their EU and non-EU investor base—play an important role in the financing of the EU economy. Approximately €3.2 trillion of UCITS assets

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\(^6\) Source: Investment Company Institute tabulations of Morningstar Direct data. © 2016 Morningstar. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.
are invested in the European capital markets. Moreover, the global reach of UCITS facilitates investment in the European Union by non-EU investors. Notably, more than 1,700 UCITS authorized for sale outside the European Union are invested in European companies. The investment in EU securities by both EU and non-EU investors in UCITS has provided greater and more diverse sources of financing for European markets, which is critical to the further maturation and success of the European capital markets.

In addition, UCITS have created a substantial number of direct and indirect jobs in the European Union. These jobs include the creation and administration of UCITS, which are established in the European Union, as well as the safekeeping/custody and management of UCITS assets. Many of these jobs and functions exist in the European Union, even in circumstances in which the UCITS is sold primarily outside the European Union and/or the management of the portfolio is performed outside of the European Union. Collectively, UCITS create thousands of high-quality, well-paying jobs in the European Union and are instrumental in bolstering the EU economy.

III. Success of the UCITS Global Brand Depends upon Strong Regulatory Framework That Allows UCITS to Maximize Efficiency

Delegation has enabled fund managers to offer UCITS with a wide range of investment strategies and to operate UCITS efficiently by utilising the best possible expertise wherever it is located. The UCITS Directive provide a comprehensive and rigorous framework with appropriate regulatory oversight of delegation that allows funds to be operated with maximum efficiency.

A. Delegation Fosters Efficiencies in Asset Management That Benefit Investors

As the industry has matured, asset managers have developed ways to bring efficiency and expertise to the operation of funds on a global basis. Delegation enables UCITS to access investment expertise around the globe in a cost-effective manner and to take advantage of economies of scale and other efficiencies. Many fund managers run funds in multiple jurisdictions, such as the European Union, United States and Hong Kong. They often choose to operate certain functions, such as portfolio management, trading research, compliance and administration in the domicile of the UCITS, the headquarters of the fund manager, and/or another jurisdiction that is particularly conducive to those functions. This centralisation enables the fund manager to cultivate centres of excellence and maximise the cost savings and efficiencies that can be derived from consolidation. The benefits of the freedom to locate functions where they can be best performed are passed on to investors in the form of greater expertise, better service, and/or lower costs.

Under the current framework, fund managers are able to provide UCITS with the portfolio management expertise and other services they believe are best suited for that UCITS, taking into

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7 Id. Data include exchange-traded funds but exclude funds that invest primarily in other funds.

8 Id.
consideration various factors, including efficiency and economies of scale. By providing services to a UCITS without regard for the location of the portfolio manager or other service provider, UCITS managers are able to source expertise to increase returns and lower costs for UCITS and their investors. For example, a global equity-focused UCITS sponsored by a fund manager with operations worldwide may utilise portfolio managers located in Frankfurt, New York City, and Hong Kong for different sleeves of the portfolio because it can tap into the best portfolio management expertise for these investments. A constriction of the flexibility provided by the existing regime would impact how asset managers can provide the best investment and other expertise to the UCITS they manage, likely at the expense of UCITS investors.

B. UCITS Directive Permits Delegation to Benefit UCITS While Allowing Competent Member State Authorities to Regulate Appropriately

The UCITS Directive recognises the importance of delegation to the operation of UCITS and provides for portfolio management and certain other functions to be delegated, including outside of the European Union. At the same time, the current regulatory framework provides for strong oversight of delegation by Member State regulators that serve to protect investors. Specifically, delegation is subject to conditions that include a requirement that: (1) the delegation of functions cannot prevent effective supervision of the management company and must not prevent the management company from acting or the UCITS being managed, in the best interests of investors, and (2) the management company must have measures in place to enable it to monitor effectively the activity of delegates. Individual Member State laws govern the parameters regarding delegation, and Member State competent authorities must in any case ensure that authorized management companies do not delegate their functions to the extent they become in effect letter-box entities and, thereby, hinder effective supervision. Additionally, delegation does not affect the liability of the management company. If any problem occurs, the management company (which must be established in an EU Member State) will be held primarily responsible by the national regulator.

C. Non-EU Regulators Have Trust in the UCITS Framework

The substantive, but yet flexible, UCITS regulatory framework has engendered significant trust among non-EU regulators and enabled investors in many jurisdictions to invest in UCITS. As stated above, more than one third of UCITS assets are currently in UCITS distributed outside of the EU, and UCITS are available to investors in more than 75 countries around the world. This trust and confidence in the UCITS framework recognises that the regulatory requirements applicable to UCITS have been developed with the best interests of investors in mind, wherever they are located. In fact, the Hong Kong Securities and Futures Commission has explicitly recognised the value of allowing services
to be provided to a fund from the most appropriate source, regardless of the location of the service provider.\textsuperscript{9}

Imposing additional regulatory hurdles on delegation outside the European Union may undermine the trust and confidence that non-EU regulators have had in UCITS, causing them to reconsider the authorisations for distribution of UCITS within their jurisdiction. Moreover, any regulatory policy that focuses not on investor protection but rather on the locality of the service provider may invite non-EU regulators to consider applying similar location-based requirements on their funds or managers, which would impact the ability of EU asset managers to provide services to non-EU domiciled funds. Additionally, restrictions on delegation may bolster the attractiveness of other fund vehicles to become the global fund vehicle of choice. Already, there have been efforts by a number of jurisdictions to launch and use other fund passport vehicles successfully, such as the Asia Region Funds Passport and the Latin American Funds Passport. A regulatory policy that has protectionist consequences (even if unintended) could encourage global asset managers to consider another investment option for non-EU investors.

IV. Proposed Article 31a Does Not Provide Added Benefits to the Existing Framework or Address Any Particular Concern with Delegation

As described above, the current UCITS Directive provides a strong regulatory framework for Member State authorities’ oversight of delegation. Article 31a of the ESA proposal does not provide added benefits to the existing UCITS framework and could have negative (even if unintended) consequences to UCITS as the global vehicle of choice by investors and fund managers. If EU policymakers believe greater convergence of delegation practices or harmonisation of standards are necessary, ESMA should use its existing powers to achieve those goals.

A. ESMA Already Has Authority to Harmonise Standards for Delegation That Can Be More Effectively Deployed

Article 31a, as drafted, would grant ESMA specific power to opine on whether the authorisation of a UCITS fund manager that proposes to delegate or outsource a material part of its activities outside the European Union is in compliance with EU rules\textsuperscript{10} If ESMA determines that a proposed authorisation is non-compliant with European Union law, ESMA would be entitled to issue an opinion to that effect. These powers, specific to delegation, however, are not needed because, under Article 17 of the existing


\textsuperscript{10} E.g., ESMA guidelines, recommendations and opinions.
ESMA regulation, ESMA is already authorised to investigate an alleged breach or non-application of Union law, including non-compliance with delegation requirements.\textsuperscript{11} Under the existing process, ESMA may issue a recommendation setting out the action necessary to comply with Union law. If the Member State competent authority does not take into account ESMA’s recommendation, the issue may be escalated to the Commission, which may issue a formal opinion requiring the competent authority to take the action necessary to comply with Union law. Under exceptional circumstances ESMA may adopt an individual decision addressed directly to a financial market participant, requiring the necessary action. Further, Article 19 of the ESMA regulation requires binding mediation between the Member State competent authority and ESMA. The recent general and sector-specific Brexit opinions\textsuperscript{12} demonstrate ESMA’s existing power to promote regulatory convergence, including in the area of delegation, and support our view that the specific powers proposed to be granted in Article 31a are unnecessary. Together, ESMA and the Commission, have the tools needed to ensure compliance with Union law and achieve greater convergence of practices, including with respect to delegation.\textsuperscript{13}

\textbf{B. The Commission Fails to Article a Rationale for Disparate Treatment of Third-Country Delegation}

Importantly, the Commission’s proposal grants additional powers to ESMA for non-EU delegations but maintains the current process for delegation to other EU entities. The Commission, however, has not provided any rationale for treating third-country delegation differently than delegation within the European Union and has not provided any evidence that such delegation negatively impacts investor protection or financial stability. We urge policymakers to refrain from deviating so significantly from the current process for third-country delegations absent justification for and consultation on the different treatment of non-EU delegation.


\textsuperscript{13} For example, the Supervisory Coordination Network was created following the issuance of the ESMA opinions in July 2017 in order to “promote consistency of decision-making by NCAs.” See, Brexit Asset Management Opinion, paragraph 7. We understand that the Network has recently undertaken consideration of certain UCITS delegation arrangements authorized by Member State competent authorities.
C. ESMA Should Focus Its Efforts Where Needed

Rather than granting ESMA new powers specific to delegation, the Commission should encourage ESMA to resolve already identified challenges. For example, there is ample evidence of significant barriers to the cross-border distribution of UCITS throughout the European Union.\(^{14}\) We believe that ESMA should focus its efforts and finite resources on streamlining the Member State authorisation and cross-border marketing notification and filing processes. Harmonising these areas offers the potential to (1) identify and adopt good or best practices and experience, (2) ensure consistency, (3) reduce complexity and cost, and (4) improve efficiency to strengthen the single market for UCITS.

V. Limitation on Delegation Would Likely Have a Detrimental Impact on UCITS and Their Investors

A change to the process for approving delegation and potentially limiting a management company’s ability to delegate portfolio management outside of the European Union could lessen the quality of the investment expertise that is available for a given UCITS, which ultimately may lead to poorer performance of the fund. Additionally, to accommodate restrictions on delegation, fund managers may need to create redundancies and set up structures utilising resources in a manner that is neither efficient, nor cost effective. Both of these factors would likely impact an investor’s returns negatively.

To the extent that delegation outside of the European Union becomes too cumbersome or severely restricted, fund managers may be unable or unwilling to continue to offer the wide breadth of UCITS investment strategies that are currently available. The investment options of millions of current and prospective UCITS investors could be seriously constricted. Faced with more limited investment options, and perhaps cognizant of the restrictions on UCITS accessing investment expertise outside of the European Union, investors may choose to forego UCITS and instead invest in other types of collective investment vehicles or products. These investors would lose the benefits and protections provided by the well-established UCITS regulatory regime.