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Evolution of the Legal Framework for UCITS Funds in the European Union (1985–2023)

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Abstract: A major driver of global economic growth since the mid-1950s, investing activities have substantially bestowed to the development of the EU Member States, some of which, e.g., Luxembourg, have even risen to the top of the European economic pyramid. The year 2025 will mark the 40-year anniversary of the legal framework for collective investment funds, which prompts the researcher to turn to the roots of the system and assess the weaknesses and strengths of EU relevant legislation. The first stop of the journey is the Directive 85/611/EEC, which allowed creating the UCITS sub-sector as a part of the single market for financial services. In fact, one can identify four key stages the European regulatory system related to collective investment has so far passed through. With every new stage, the fund industry got a big boost, and regular updates to the legal system resulted in 29 thousand UCITS funds holding more than € 8 trillion in assets in 2022. In recent decades, the regime for UCITS has been conducive to European economic success. This is the strong reason why the 40-year-long evolution of the system should be at the forefront of our attention.

***Keywords*:** the European Union; European Union law; financial law; investment law; financial integration; internal market; single market for financial services; UCITS; legal framework for UCITS

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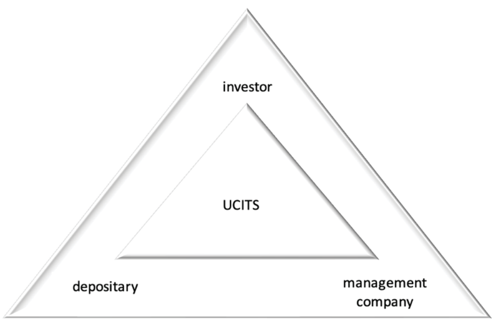
I. Introduction

Nowadays the European Union (EU) boasts a large network of collective investment funds (CIFs) that fall under the undertakings for collective investment in transferable securities (UCITS) legal framework. This can be accounted for by two factors: 1) the necessity to ensure the appropriate level of investor protection and 2) the Member States' (MS) commitment to increasing the number of UCITS as an instrument to attract more investment and ensure stable economic growth on a national scale.

The European Court of Auditors estimates that the significant part of the operational funds in question were established in Luxembourg, Ireland, Germany and France, with Luxembourg and Ireland managing the biggest part of all net assets of UCITS. By late 2020, € 11.6 trillion[1] was invested in UCITS, which testifies to their reliability and effectiveness.



[1] The European Court of Auditors. Special report 04/2022 "Investment funds EU actions have not yet created a true single market benefiting investors" (Luxemburg, 21.02.2022).

Before moving on to the analysis of the regulatory framework, let us emphasize the following points. Firstly, from a legal standpoint, all investment relations can be characterized as a triangle, with the funds being at the center of this arrangement and the three corners constituting 1) the investor, 2) the depositary and 3) the management company (MC) (Zetzsche, 2012, p. 13). This structure is key to understanding the sub-sector of UCITS and represents the object of the study. Secondly, foreign scholars tend to categorize all the adopted directives and directive proposals governing UCITS into different types, identifying UCITS I–IV and at times even UCITS I–V. The classifications mentioned hereinbefore are at the core of this paper.

II. Investor

The road to integrated financial services markets in Europe has at times been somewhat bumpy. The year 1973[2] saw the emergence of a single market for financial services (SMFS) in what is now the European Union; yet certain steps towards financial integration had been taken even earlier. Article 67 of the 1957 EEC Treaty[3] obliged its MSs to remove restrictions and abolish discriminatory treatment affecting capital movements between them, but yielded little to no result. In 1960s, at the dawn of European integration, the Segré Report (Segré, 1966) prepared by the highly qualified expert panel held that the economic growth was continuously becoming more dependent upon capital markets with the convergence of the MSs economic policy facilitating such growth (Shokhin and Kudryashova, 2023, p. 97). At the time, it became obvious that universal approaches to CIFs would serve as a catalyst for integrating the financial markets, benefiting in the long run both the European economy and investors, where new investment opportunities for the latter could contribute to the growth opportunities for the former.

Scaling up investment required European lawmakers to address poor investor protection. It is clear that investor protection is

[2] Communication from the Commission "Implementing the framework for financial markets: action plan" (Brussels, 11.05.1999). COM/99/0232. P. 1.

[3] Treaty establishing the European Economic Community. Rome. 25.03.1957.

fundamental to the natural and wholesome evolvement of financial marketplaces (Pimlott, 1985, p. 154), and countries where investors are duly protected are associated with higher valuation of corporate assets, financial development and economic growth (La Porta, 2000, pp. 13–15).

The major problem of inadequate investor protection was to be solved at a supranational level. The fact is that by the mid-1980s, each MS had developed their own legal frameworks for the regulation of CIFs, sometimes varying markedly from country to country. The differences could be linked to, amongst other things, legal forms of funds, investment objects, the legal status of investors, so as the protection level of the latter. The plan was to harmonize the patchwork of legal rules governing CIFs by means of directives. In reality, being far from an ideal form of legal approximation in terms of its predictability (Kurcz, 2001, p. 290), this "soft" approach did not bridge the existing gaps between the ways in which a fund operated in a MS where it was established and the ways in which it engaged in cross-border activities.

Another important aspect of the problem is the classification of all CIFs into two types, namely open-ended and close-ended funds. This must be taken into account, because the legislative acts below apply exclusively to the former allowing private investors to buy and sell units at any time. With very few exceptions, such investors lack the relevant expertise and therefore need additional layers of protection in most cases. This is regardless of the fact that they tend to embrace conservative investing strategies.

III. UCITS

The Commission's Proposal of 14 April 1976 for a Council Directive regulating collective investment undertakings for transferable securities[4] (CIUTS) represents a stepping-stone to creating a sub-sector of CIFs. As is clear from the instrument's title and content, the authors employed

[4] Proposal for a Council Directive for the coordination of laws, regulations and administrative provisions regarding collective investment undertakings for transferable securities. COM/76/152. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A51976PC0152&qid=1718799869211. [Accessed 15.05.2024].

the term for some theoretical reasons. Indeed, the acronym "CIUTS" was used to refer to all the CIFs within the Community, including, for example, unit trusts in the UK or mutual funds in France.

In accordance with Art. 198 of the 1957 Treaty of Rome, the Proposal was submitted for consultation to the European Economic and Social Committee (EESC). Generally speaking, the document which would mark the first step to establishing the sub-sector of CIFs was welcomed by the Committee, the Council, and the Parliament. At the same time, the Committee made a few important comments on the matter, stating, for example, *"Even if the Directive did bring about complete freedom of movement for securities through rules ensuring equal conditions of competition, freedom of movement might still be impeded by other national rules and regulations,* e.g., *foreign exchange regulations or tax provisions."*[5] This testifies to insufficient harmonization of legal relations covered by the 1976 Proposal. Consequently, CIUTS established in those MSs where the CIFs were subject to stricter financial market rules were less advantageous as compared to CIUTS constituted in the MSs with only minimum requirements applied to CIFs.[6] However, the lack of proper regulation of CIFs increases the likelihood of financial instability and, hence, risks for private investors (Avgouleas, 2009, p. 54), which led the EESC to think of the Directive as a critical step forward towards the coordination of the present legal acts in force in the Community.

Having received a lot of feedback on the 1976 Proposal, the Commission made a number of amendments to it,[7] which was followed by yet another round of lively debate. Notwithstanding that the issue had been brought up at the pan-European level back in the mid-1960s, it was not until 1985 that tangible results were finally achieved.

[5] Opinion of the Economic and Social Committee on the proposal for a Council Directive for the coordination of laws, regulations and administrative provisions regarding collective investments for transferable securities. OJ C 75, 26.03.1977. Pp. 10–16.

[6] Opinion of the Economic and Social Committee on the proposal for a Council Directive... P. 2.

[7] Amendment to the Proposal for a Council Directive for the coordination of laws, regulations and administrative provisions regarding collective investment undertakings for transferable securities. COM/77/227.

The next major step towards providing a supranational framework for the European SMFS is linked to Lord Cockfield's White Paper of 1985,[8] a compendium of almost 300 legislative proposals put forward by the Commission. Dealing with different internal market's sectors, the proposals — and the Paper itself — sought to eliminate the impediments to cross-border commerce by 1992. This, in its turn, would result in greater competition and a wider range of goods and services, thus influencing the latter's prices (Smith and Venables, 1988, p. 1501). As for the financial sector, the Cockfield White Paper envisaged the adoption of about 20 legislative acts covering three major sectors of the SMFS, notably banking and insurance sectors, so as securities market (Kasyanov, 2019, p. 599), and, what is equally important, the explicit reference to the 1976 Proposal was made. However, the 1985 document referred to these establishments as "undertakings for collective investment in transferable securities" (UCITS). It shall be pointed out that 1976 was marked by the European Parliament (EP) accentuating the necessity to elucidate the Proposal, particularly its term "CIUTS," the origins of which remain obscure. This institution recommended adding the wording "of the open-ended type." The Commission must have paid heed to the message, as the title of the 1977 document amending the Proposal had the words "other than of the closed-end type."

The marathon talks produced the Directive 85/611/EEC of 20 December 1985, which came to be known as "the original directive" or "UCITS I" (Anderberg and Bolton, 2006, p. 13). Importantly enough, the terminology "other than of the closed-end type" was not included in the first and subsequent directives.

The necessity to develop the UCITS sub-sector within the SMFS, which would enable private investors to make a greater profit, was stressed by the preamble of the Directive 85/611/EEC. It argued that *"National laws governing collective investment undertakings should be coordinated with a view to approximating the conditions of competition between those undertakings at Community level, while at the same time ensuring more effective and more uniform protection*

[8] Completing the Internal Market: White Paper from the Commission to the European Council (Milan, 28–29 June 1985). COM/85/0310.

for unit-holders.”[9] In other words, the objective behind the Directive was twofold: to protect UCITS investors and to create a level playing field for such schemes at the supranational and domestic level. For harmonization at the latter level, the document set forth uniform minimum requirements for UCITS related, say, to authorization, legal forms, and the information that the competent financial authorities were supposed to be provided with.

Let us look at Art. 1 of UCITS I offering the definition of the undertakings under analysis. The legislators decided to introduce the term, describing its two key features. Firstly, the Article clearly defines the function of the establishments in question, ascertaining that the sole objective of the latter, judging by the name itself, is the collective investment of funds raised from the public in transferable securities. Secondly, it provides that upon the holders’ claim, the units of such establishments shall be repurchased or redeemed out of the UCITS assets. Moreover, the UCITS actions aimed at procuring that the units’ stock exchange value does not substantially differ from the net asset value are considered equal to the aforementioned repurchase or redemption. In essence, this requirement constitutes a medium for maintaining an appropriate degree of liquidity, which allowed investors to redeem their investment either at a market price or at an initial purchase price.

The Directive 85/611/EEC, thus, views UCITS as CIFs which seek only to invest in transferable securities of capital raised from private investors and operate the investment portfolio on the principle of professional management and risk-spreading. At the same time, Art. 19 specifies that transferable securities shall be those that are officially listed on the stock exchange or traded on other similar regulated markets. UCITS I did not cover issues regarding the use of derivatives, which, however, does not mean that at the time there were no CIFs investing in them. Rather, such funds in the EEC MSs were governed by national legislation, which, in the final analysis, means that they were excluded from the sub-sector.

[9] Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). OJ L 375, 31.12.1985. P. 1.

Remarkably, Art. 53 of UCITS I sets up a Contact Committee as the body responsible for ensuring cooperation between the financial supervisory bodies of the EEC MSs. At first, it had a purely advisory function, meaning that it was to provide the Commission with some advice on how to amend or make certain additions to the analyzed Directive, and to assist the MSs in implementing the legislative act or taking extra measures in case a UCITS situated in one MS intended to sell and promote its units in another MS following proper notification (please, see below for more detail). As from 2001, where it was vested with the comitology function, the Committee became a regulatory body under Art. 5 of the Second Council Decision on implementing powers[10] of 28 June 1999. Broadly speaking, being an initial endeavor to enhance cooperation on UCITS, the Contact Committee failed to achieve consistency in law enforcement at the national level and to build bridges between the financial supervisory bodies. To put it another way, the Committee fell short of high expectations, which was admittedly related not only to its performance but also to some flaws of the comitology system.

Although the Directive 85/611/EEC prevented MCs and depositaries from operating in the MSs where they did not have their registered offices (Ciani, 1996, p. 153), the opposite was the case with UCITS. That was the crowning achievement of the Directive, in that it *"opened the door to the single European market for investment funds, enshrining, for the first time, the concept of a European passport based on the free establishment and provision of services"* (Entin and Entin, 2021, p. 152) by UCITS funds. According to this concept, it was mandatory for the national competent authorities of all MSs to recognize the license issued by the UCITS country of origin, which, in its turn, meant that such UCITS was empowered to provide its services within the entire Community. At the very heart of the conception lies the mutual recognition mechanism (Ortino, 2007, pp. 309–338) repeatedly referred to by the analyzed directives. It was first described in the Cockfield White Paper of 1985 adopted by the MSs as part of the preparation for signing the Single

[10] Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission. OJ L 184, 17.07.1999, pp. 23–26.

European Act one year later. Commissioner for Internal Market and Services, Lord Cockfield drew upon the approach advocated by the Commission since the "Rewe-Zentral v. Bundesmonopolverwaltung für Branntwein" case, aka the "Cassis de Dijon" case (Cini and Borragán, 2016, pp. 261–262). It implies that the MSs mutually recognize the regulatory groundwork, trusting each other when it comes to proper supervision of the organizations (Lomnicka, 2000, p. 325).

Yet the mechanism has not always produced the desired result, as detailed below. During the initial stage, a UCITS had to be authorized by the supervisory bodies of the MS of its origin. Depending on the latter, the aforementioned authorities could range from banking regulators to those overseeing the securities market or the UCITS sub-sector. In accordance with the Directive 85/611/EEC, unit trusts were obligated to submit the following data for authorization purposes: 1) the constitutional documents, including the investment policy and financial objectives presentation; and 2) information concerning the MC, the depositary and the directors. As regards investment firms, they could be authorized should the competent authorities in their home MS approve the constitutional documents and the information about the depositary and the directors. There was no need to send the details of MCs, as investment firms might do without them when performing their functions.

In addition, UCITS I unequivocally denotes that the home MS's supervisors shall be empowered not to license the schemes under consideration, unless the MC's, depositary's or investment firm's directors are of good repute and they have a due level of experience required to exercise their respective duties. Authorization implied that the applicant had a business plan and a commercially sound and viable structure, which clearly guaranteed that investment in transferable securities was relatively safe (De Cecco, 2006, pp. 9–30) and retail investors were properly protected.

At first glance, a UCITS could begin to sell and promote its units in the host MS upon receiving permission from its MS's supervisory bodies. In practice, that was not the case. To secure such permission, it was obligatory to apprise the competent bodies of the host MS of the intent to sell units, which involved sending the documentation previously submitted to the national financial regulator and the information concerning the European passport. The UCITS operations might commence in the host country two months after such communication unless the authorities established that the preparatory activities carried out so that the UCITS could start selling its units did not correspond with the relevant provisions. During the period in question, the regulators were entitled to necessitate the translation of the documents, which could be a costly and time-consuming process. To top it off, the host authorized bodies could raise some objections to the undertaking's marketing strategy, that is to say, the way it provided services and promoted investment products in the market (Buttigieg, 2013, p. 193). Some MSs went so far as to exploit UCITS I to lay down their own passporting rules. Although they justified the measures by claiming that certain characteristics of UCITS did not meet the criteria set forth by the Directive, this was inconsistent with the mutual recognition mechanism. Such policies allowed protecting local CIFs from those situated in other MSs.

Commenting on the notification procedure, the Commission, for its part, lamented that *"difficulties have arisen in respect of its smooth functioning. <…> the formalities, length and complexity of the notification procedure may vary greatly from one Member State to the other. If some of these variations can be explained by different administrative practices, many of them also result from diverging interpretations of the Directive."*[11] Moreover, the EP had turned to this issue as early as during the preparation of UCITS I, which can be exemplified by Lord Ardwick's quote, *"The coordination measures contained in the proposed directive are incomplete, as each Member State will continue to apply its own marketing regulations to units of CIUTS marketed on its territory."*[12]

[11] Interpretative Communication from the Commission "Respective powers retained by the Home Member State and the Host Member State in the marketing of UCITS pursuant to Section VIII of the UCITS Directive" (Brussels, 19.03.2007). COM/2007/0112. P. 2.

[12] European Parliament. Working documents (1976–1977). Report on the Proposal from the Commission to the Council (Doc. 114/76) for a directive for the coordination of laws, regulations and administrative provisions regarding collective investment undertakings for transferable securities. PE 46.460/fin. Pp. 4–6.

Given the aforementioned, one can stress that at the national level, there were regulatory hurdles surrounding the cross-border trade of UCITS units, which not only frustrated the efforts to make use of mutual recognition, but also undermined the credibility of the European passport. It all points to the tentative conclusion that back then the EEC faced three impediments to embracing the mutual recognition mechanism. The list includes inconsistent interpretation of UCITS I, controversial effects of its implementation and the considerable latitude the MSs enjoyed in ensuring that UCITS complied with the national financial regulations arising from the Directive.

With the Directive in effect on 1 October 1989, the MSs should have brought into force the relevant measures by that time. However, the Portuguese Republic and the Hellenic Republic were authorized to postpone the implementation until 1 April 1992, because their financial services eligible under UCITS I fell a long way short of those in the other EEC nations.

Despite the fact that UCITS I is the first important step towards the construction of the UCITS sub-sector, it had only limited, albeit significant, impact in terms of the integration in the financial services industry. The first serious attempt to amend the regulation was made in February 1993 when the Commission tabled a Proposal[13] seeking to remedy the shortcomings of the Directive. More specifically, it proposed to expand its scope to include funds of funds and money market funds. While the former refer to schemes typified by investing in other funds, the latter constitute mutual funds that invest in highly liquid, short-term instruments such as certificates of deposit and government securities.

Seventeen months later, following open discussion with the sub-industry and the EESC's opinion[14] on the Proposal of 1993, the

[13] Proposal for a Council Directive amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS). OJ C 59, 02.03.1993. Pp. 14–18.

[14] Opinion of the Economic and Social Committee on the proposal for a Council Directive amending Directive 85/611/EEC on the Coordination of laws, Regulations and Administrative Provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS). OJ C 249, 13.09.1993. Pp. 15–21.

Commission published an amended Proposal[15] of 20 July 1994. Both documents of 1993 and 1994 are dubbed "UCITS II" (Buttigieg, 2014, p. 85). The Proposal of 1994 contained the amendments related to the new legislative mechanism that had been introduced in November 1993 by the Treaty of Maastricht.[16] The EP was now empowered to make decisions in this realm in conjunction with the Council, which, in its turn, testifies to the extended role of the institution.

Apart from the above-mentioned funds, the Proposal of 1994 extended UCITS I scope to cash funds and master-feeder schemes. While other types of funds are rather familiar, the master-feeder ones require particular consideration. They constitute such CIFs where the funds contributed to several "feeders" by different categories of investors (for example, from different jurisdictions) are pooled into one "master." In other words, investors allocate money to feeder funds, which ultimately invest assets into the centralized master fund responsible for making all portfolio investments (Adema, 2014, p. 653). The scheme is mainly designed to reduce tax burden and enhance operational efficiency. Last but not least, its size offers sufficient scope for the most favourable terms from depositaries, auditors and other financial service providers, which is the case of the economies of scale. When it comes to cash funds, they are defined as CIFs which invest in short-term and low-risk securities. Elaborating on the incorporation of cash funds and money market funds into the UCITS sub-sector in 1995, the European Monetary Institute welcomed the Proposal since *"The new funds will, as a general rule, be subject to the same supervisory standards as are already laid down for UCITS and which have so far proven to be effective."*[17]

[15] Amended proposal for a European Parliament and Council Directive amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS). COM (94) 329.

[16] Consolidated version of the Treaty on European Union. OJ C 326, 26.10.2012. Pp. 13–390.

[17] Opinion of the European Monetary Institute on a consultation from the Council of the EC under Art. 109f (6) of the Treaty establishing the European Community and Art. 5.3 of the Statute of the EMI; on a Commission proposal for a EP and Council Directive amending Directive 85/611/EEC on the co-ordination of laws, regulations

With this in mind, one can arrive at the conclusion that the updates to UCITS I as detailed in the Proposal of 1994 would have shaped the market, as the CIFs under the scope of UCITS would have appeared more attractive to private investors. However, amid the controversy surrounding the issue, the negotiations reached an impasse within the Council and the EP. Under such circumstances, a new proposal with a greater number of funds related to UCITS never materialized, even though where March 1995 was marked with the Council's recommendations as to the submission of the amended document by the Commission. The failure to adopt UCITS II arose from the EEC nations' drive to shield their financial industries, the major obstacle to creating a more effective legal framework for the regulation of UCITS.

On 1 January 1999, the Euro was adopted as the official currency in 11 out of 15 EU MSs meeting the Maastricht criteria, which gave fresh impetus to the stalled talks on the Commission's proposals. As Financial Services Commissioner Mario Monti put it, *"The single currency will bring these obstacles into sharp relief by encouraging cross-frontier investment and increasing competition."*[18] By this very idea, a sense of urgency as to the necessity of integrating European financial markets was added. Apart from this, there were objective factors determining the impact of the integrated sub-sector of UCITS. The EU conducted research into CIFs, proving that the following benefits would be at the very core of the sub-sector's evolvement: 1) the implementation of the economies of scale, which would manifest in the reduction of costs, 2) increased competition, and 3) the increased number of financial services for non-institutional investors (Heinemann, 2002, p. 4). This does highlight the relevance of continuous and consistent integration efforts in the sphere at issue.

July 1998 saw the second attempt to update the UCITS regulatory framework, with the Commission publishing two proposals making amendments to UCITS I. Whereas the first, the 1998 MC and prospectus

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and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (Brussels, 27.07.1995). CON/94/8. P. 2.

[18] European Commission. Press release. Financial services: Commission proposes to improve and extend rules on collective investment undertakings (Brussels, 17 July 1998). IP/98/673.

Proposal, aimed to regulate MCs and establish a uniform simplified prospectus,[19] the second, the 1998 Proposal on funds, obviously, dealt with a greater number of schemes.[20] As is seen from both proposals, the Commission did not examine the necessity to provide depositaries with the European passport (for more detail, please see below). Having taken into account the poor track record of the previous legislative initiatives, the body prepared two documents, because *"The separation of topics involving different problems could facilitate the negotiating process in the Council. It will not matter if one of the two Directives is adopted more rapidly than the other one."*[21]

The forenamed modification of the mechanism for making amendments became a source of worry for the EP that was outspoken in its support for having two proposals being considered together and transposed concomitantly. Pointing out that some provisions were vague and at times beyond comprehension, the Parliament emphasized the necessity to swiftly prepare a single over-arching document governing UCITS.[22] The European Central Bank also contributed to the discussion, saying the following, *"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*

[19] Proposal for a European Parliament and Council Directive Amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS) with a View to Regulating Management Companies and Simplified Prospectuses. COM (1998) 451.

[20] Proposal for a European Parliament and Council Directive Amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS). COM (1998) 449.

[21] Proposal for a European Parliament and Council Directive Amending Directive 85/611/EEC... COM (1998) 449. P. 3.

[22] Committee on Economic and Monetary Affairs. Report on the proposal for a European Parliament and Council directive amending Directive 85/611/EEC (COM (1998) 449) and on the proposal for a European Parliament and Council directive amending Directive 85/611/EEC with a view to regulating management companies and simplified prospectuses (COM (1998) 451). A5-0025/2000. P. 29.

certainty, discussion of a complete and integral new version of the UCITS Directive would be preferable."[23]

In fact, the ECB tried to make it clear that the adjustment in the mechanism for amending the financial services directives could do damage to the system of investor protection since the MSs had divergent approaches to the proposed changes back then. This means that the adoption of the two UCITS Directives would have badly disrupted the market. In this context, financial stability was at the top of the agenda. After all, the financial trilemma which states that (1) financial integration, (2) financial stability and (3) national financial policies are incompatible (Schoenmaker, 2011, p. 2) has been part and parcel of the regulatory policy on UCITS. Thus, the euro paired with even more integrated financial markets would have increased the risk of the cross-border domino effect, as the bankruptcy of one financial institution could have influenced institutions elsewhere. Such events, which are now known as the systemic risks, in their turn, would have reduced economic value or consumer confidence in most of the EU financial arrangements.

Additionally, the ECB's remarks reflected the concerns of some Member States' competent authorities regarding the potential negative effect of the default on the financial system at large. This concern emerged after the downfall of LTCM in September 1998.[24] The American fund's investment policy was based on convergence trading, which involved buying undervalued securities and selling overvalued ones, expecting that prices would eventually converge to fair values (Szylar, 2010, p. 173). At that time when the 1998 proposals were under consideration in the EU, the Federal Reserve System made different US financial institutions bail out LTCM, because the creditors feared that the fund's significant losses would cause its default. Fundamentally speaking, the decision to save LTCM was based on the "too big to fail" doctrine postulating that the government has to rescue big funds from

[23] Opinion of the European Central Bank of 16 March 1999 (CON/98/54). OJ C 285, 07.10.1999. P. 1.

[24] ECB. Large EU banks' exposures to hedge funds. 2005. P. 8. Available at: https://www.ecb.europa.eu/pub/pdf/other/largeeubanksexposureshedgefunds200511en.pdf [Accessed 07.12.2023].

insolvency for the very reason that they are big (Moosa, 2010, p. 319). Initially applicable to the banking sector, the principle is not limited to CIFs but extends to other major financial institutions. Without a doubt, the LTCM mishap showed the immediate interdependence between the economy, monetary policy and CIFs.

Not surprisingly, amid such events, European officials, including those from the ECB, shifted their focus on both the systemic risks of CIFs and prudential supervision. It gradually became apparent that the system characterized by the considerable autonomy of MSs, the want of uniform construction of the provision of European legislation, as well as the lack of convergence of supervisory practices at the national level could dilute the efficacy of the domestic competent authorities and, thus, lead to the obstructive actions of the authorized bodies of the host MS (Moloney, 2003, p. 810).

In 1999, the Commission introduced its Financial Services Action Plan (FSAP),[25] which was considered as a crucial move towards the creation of a SMFS (Meshcheryakova, 2019, p. 10) and its UCITS sub-sector. Not only did this lengthy document cover almost all regulatory issues, but it also strove to introduce a more advanced legal framework for European financial markets. Regarding the SMFS available to retail investors, Baron Alexandre Lamfalussy, one of the founding fathers of the euro, was of the opinion that it was still in the making (Lamfalussy, 2002, p. 1289).

Curiously enough, the Committee of Wise Men, an expert panel that produced the Lamfalussy Report in 2001, denoted that *"Integrated European markets with more flexible investment rules, therefore, should improve the risk-return frontier."* Moreover, *"steps to relax regulatory constraints... should sustain a greater presence by European funds."*[26] As a consequence, one of the 42 FSAP legislative measures called for the

[25] Communication from the Commission "Implementing the framework for financial markets: action plan" (Brussels, 11.05.1999). COM/99/0232.

[26] Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets chaired by A. Lamfalussy (Brussels, 9 November 2000). Available at: https://web.archive.org/web/20130405002910/http:/ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/initial-report-wise-men_en.pdf [Accessed 12.12.2023].

swift adoption of the Commission's two proposals of 1998, which was definitely in line with the objectives behind the FSAP and the European institution's policy itself. It is notable that the initiative was named "the political agreement on the proposed Directives on UCITS," which attests that the MSs had divergent political views on the situation.

To some extent, the 1998 Proposal on funds echoed the Proposal of 1994. More specifically, it again recommended extending the list of funds qualifying as UCITS to money market funds, funds of funds, and cash funds. It is worthwhile mentioning that the Proposal in question did not extend the range of permissible investments to allow master-feeder funds in UCITS form. It all means that the endorsement of the Proposal would have removed another constraint of the UCITS legal framework, as now such establishments would have been allowed to invest in a greater number of assets, ranging from common bank deposits to other types of UCITS. It was more of a novelty to see this kind of changes. Along with keeping proper investment protection, introducing extra CIFs would have required the EU to set additional standards and/or update the existing ones, with the aim of cushioning the possible investment risks. To this end, the 1998 Proposal on funds set greater transparency standards.

In reality, one can say with certainty that enabling fund managers to employ more diverse investment strategies was nothing but an attempt to address the ineptitude of UCITS I to create a broader sub-sector of CIFs.[27] During the deliberations of the 1998 Proposal on funds with the ECB and EESC rendering their opinions, some recommendations were made as to the necessity to have some aspects of the Proposal clarified and the list of UCITS investment portfolio's assets extended. Namely, there was general consensus that UCITS partaking in the transactions carried out with derivatives shall not be confined to the standardized instruments, e.g., options and futures, quoted on the stock exchange, but should rather be spread to the OTC (over-the-counter) derivatives. The list includes, for example, forward contracts and swaps. The former stand for the type of bargains, where the underlying asset is agreed to

[27] Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets chaired by A. Lamfalussy. Pp. 4–5.

be traded at a predetermined price on a future date (Rayzberg, 2022, p. 460), while the latter encompass contracts under which the parties exchange different assets for a given period of time (Rayzberg, 2022, p. 386). As regards the EP, it was in favor of the dominant approach to the issue. Against the background of the OTC derivatives market development, it was essential to ensure that the regulation of UCITS-related assets was flexible enough so that the relevant organizations could adjust to the changing market conditions in the most effective way possible.[28]

In 2000, the Commission made amendments to its Proposal on funds primarily related to liberalizing a UCITS ability to use OTC derivatives eligible only where such instruments could be liquidated or sold on a daily basis.[29] Applauded by European policy makers, this change was finally adopted in the Directive 2001/108/EC,[30] Art. 19(1) in particular. Furthermore, one can claim that such legislative modifications set in motion the evolution of UCITS from a simple retail investment product into a widespread investment tool to deal with complex funds with their units traded throughout the Union and other countries to retail investors (Amenc and Sender, 2010, p. 25). This was regulated by Art. 1(9), Art. 19(1), and Art. 53(3) of the document.

Along with propelling the development of the sub-sector of CIFs, the Directive 2001/108/EC brought about a number of investor protection and financial stability problems, as absent proper regulation and supervision and the wider scope of UCITS schemes would have jeopardized the financial markets. That was a particularly burning issue amid the demise of LTCM in the 1990s.

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[28] Committee on Economic and Monetary Affairs. Report... A5-0025/2000. P. 30.

[29] Amended proposal for a Directive of the European Parliament and of the Council amending Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). COM (2000) 329.

[30] Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS. OJ L 41, 13.02.2002. Pp. 35–42.

As said earlier, the EP, on the one hand, insisted that UCITS should become part of OTC derivative transactions. On the other hand, it stressed the importance of such investments being made taking into account certain qualitative and quantitative criteria for the sake of safeguarding the investor protection.[31] The Council was of the same opinion and produced the minimum capital requirements with which UCITS investing in OTC derivatives were supposed to comply,[32] a crucial step given that the derivatives in question are not liquid in most cases. Article 21 of the amended 1985 Directive, thus, stipulated that the global exposure relating to financial derivative instruments may not exceed 100 % of the UCITS net asset value and that counterparties involved in OTC derivative contracts must adhere to prudential requirements and be authorized to operate in the MS where a UCITS was situated. Additionally, the Directive 2001/108/EC laid down that the management of risks shall be effectuated by UCITS themselves or (as a general rule) by their MCs in order to monitor the balance of payments for one business day, and the methodology applied to calculate such risks was set forth in the Commission Recommendation 2004/383/EC of 27 April 2004.[33] This soft law mechanism is quite often viewed as a first step towards a uniform understanding of risk measurement methodologies in the UCITS area, the attainment of which could furnish uniform investor protection within the entire Community, as well as the level playing field for all market participants (Calverley et al., 2008, p. 59).

When not on paper, unfortunately, the risk management requirements were construed and applied inconsistently by MSs, which is why mutual recognition ran the danger of degenerating into "mutual

[31] Committee on Economic and Monetary Affairs. Report… A5-0025/2000. P. 30.

[32] Committee on Economic and Monetary Affairs. Recommendation for Second Reading on the Council common position for adopting a EP and Council directive amending Directive 85/611/EEC (1998/0243(COD)) and on the Council common position for adopting a EP and Council directive amending Directive 85/611/EEC with a view to regulating management companies and simplified prospectuses (1998/0242(COD)). A5-0324/2001. P. 11.

[33] 2004/383/EC: Commission Recommendation of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS) (Brussels, 27 April 2004). OJ L 144, 30.04.2004. Pp. 33–41.

mistrust."[34] To redress the situation, the Committee of European Securities Regulators (CESR) unveiled a set of criteria for managing UCITS-related risks and elaborated on the ways of how the Directive and the Recommendation should be followed. Seeking to ensure greater investment protection, the Directive 2001/108/EC required investors to act on the fact that the purchaser of OTC derivatives was responsible for checking their risk status. This principle was enshrined in Art. 24(a), which also obligated one to disclose extra information about the risks of acquiring this type of derivatives in their prospectus.

The year 2001 heralded the start of the Lamfalussy Process introducing a new regulatory mechanism within the EU, or rather, a qualitatively and quantitatively new system of comitology committees. The above-mentioned CESR was established (by the Commission Decision 2001/527/EC of 6 June 2001[35]) as one of the Lamfalussy comitology committees. The reference to this committee is vital due to the fact that in 2003 the Commission endorsed two decisions with each comprising of only two articles the purpose of which was that of substituting the Contact Committee with the ESC (i.e., the European Securities Committee) and the CESR (Schaub, 2005, p. 118). As a result, since 2003 the activities of the schemes under analysis started to be regulated by two committees specified. Furthermore, the ESC, which was introduced by the Commission Decision 2001/528/EC of 6 June 2001[36] among the first, belonged to the classical comitology committees. Undoubtedly, the same numbers and dates of the decisions demonstrate that the committees were designed to form a single organizational framework for the financial services across the European Union.

Those modifications provided for by the Directive 2001/108/EC were considered indispensable when expanding the scope of the regulatory regime for UCITS funds, however, they also generated some uncertainty within the market. It was during the transposition stage

[34] CESR. Risk management principles for UCITS, February 2009. CESR-09-178. P. 3.

[35] 2001/527/EC: Commission Decision of 6 June 2001 establishing the Committee of European Securities Regulators. OJ L 191, 13.07.2001. Pp. 43–44.

[36] 2001/528/EC: Commission Decision of 6 June 2001 establishing the European Securities Committee. OJ L 191, 13.07.2001. Pp. 45–46.

when it became obvious that MSs interpreted the provisions laid down by the Directive differently. Some embraced a more flexible approach to the financial instruments at their disposal whereas others opted to scrupulously observe the regulation for the sake of investors,[37] which in practice entails that investments in the same types of assets were allowed in some jurisdictions, but not in other ones. This was recognized in the Commission's Green Paper of 2005.[38] Over time, the conviction of the necessity to reform the mechanism of mutual recognition only intensified, which, in its turn, was a prerequisite to the introduction of a more harmonized UCITS legal framework, which should be combined with the approximation of the MSs supervisory authorities' practices.[39]

Amid the financial crisis of 2007–2008 that produced a bitter economic setback for many countries (Krugman, 2009, p. 184), the Commission carried out around-the-clock monitoring of the macroeconomic situation and the UCITS sub-sector itself. It is not a coincidence that in 2008, the adoption of substantial amendments to the legal rules applicable to UCITS was put forward by the Commission[40] for the first time since 1985. This crystallized into the Directive 2009/65/EC of 13 July 2009,[41] known as "UCITS IV" (Yeoh, 2009, p. 189), which marked the birth of modern regulatory legislation on the issue. It would not be remiss to say that it also represents the key source of secondary legislation controlling the use of CIFs.

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[37] CESR's Advice to the European Commission on Clarification of Definitions concerning Eligible Assets of UCITS, January 2006. CESR/06-005. P. 3.

[38] Green Paper on the Enhancement of the EU Framework for Investment Funds (Brussels, 12.07.2005). COM/2005/0314.

[39] European Commission. Financial Services: Turning the Corner. Preparing the challenge of the next phase of European capital market integration (Tenth Report) (Brussels, 2 June 2004) P. 11. Available at: https://web.archive.org/web/20160630043557/https:/ec.europa.eu/internal_market/finances/docs/actionplan/index/progress10_en.pdf [Accessed 19.12.2023].

[40] Proposal for a Directive of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). COM/2008/0458.

[41] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). OJ L 302, 17.11.2009. Pp. 32–96.

First of all, the new Directive provided a new definition of UCITS. Article 1(2) views a UCITS as an undertaking: 1) the sole objective of which is that of the investment of funds accumulated from the general public in transferable type of securities and some other financial instruments carried out collectively; 2) the actions of which are subject to the risk allocation principle, and 3) the units of which shall be, either directly or indirectly, redeemed or repurchased at their holders' request (Gheorghe, 2022, p. 142). The first point means that the entities shall promote their shares or units to the public at large, and the financial instruments issued by UCITS should be offered across the EU. As for the third point, it suggests that UCITS are entitled to redeem their units through intermediaries, namely investment firms and credit institutions (Buttigieg, 2013, p. 196).

Curiously enough, Art. 3 determines those undertakings that are not subject to the Directive. The list includes: 1) the closed-ended funds, 2) the CIFs which attract funds from the investors, but do not make any public offer as to purchasing their units throughout the EU, 3) the funds the units of which, subject to their constitutional documents, may be sold exclusively in third countries (with certain exceptions provided), and 4) the CIFs that do not meet (a) the uniform standards as to the investment policy implementation applied to UCITS schemes, so as (b) the rules concerning the proper level of borrowings, which shall be maintained by the analyzed establishments.

When it comes to UCITS funds currently regulated by UCITS IV, they encompass money market funds, funds of funds, index-tracking funds, exchange traded funds and the like. The fact that index-tracking and exchange traded funds were now part of the UCITS sub-sector turned out to be one of the greatest achievements of the European legislators, because it entailed a greater number of assets available to investors. Apart from this, the Directive allowed UCITS to operate as umbrella funds characterized by a few distinguishing features. According to Art. 49, they consist of multiple sub-funds regarded as separate UCITS funds, with each of them having their own investment portfolio and strategy (Patassi, 2015, p. 20). Another notable thing is that such structures are managed by one board of directors and entitled to appoint one depositary. It is especially important to regulate umbrella funds, since nowadays most of establishments, say, in Luxembourg, a European and international financial hub, belong to the category of umbrella funds (Hazenberg, 2016, p. 121). This speaks volumes about their efficiency and effectiveness. The basic difference between umbrella funds and master feeder funds is that in case of the former sub-funds can invest in other funds of the same type, which is subject to some restrictions imposed by the MSs.

Regarding the legal form of UCITS funds, one should say that the classification is included in UCITS IV and seems quite reasonable, because the legal structure determines who has the ownership of the UCITS assets and who is entitled to the income derived from them (Adema, 2009, p. 12). In this case, both investors and entities can be beneficiaries, as the securities purchased through a UCITS fund belong to the fund's assets, making it entitled to a share of profit. According to Art. 1(2) of the 2009 Directive, UCITS can be legally structured as mutual, or common, funds, unit trusts or investment companies.

It shall be worth mentioning that in case UCITS is established as a corporate type CIF one of the ways to consolidate the protection of investors' rights and interests is to hold investor meetings. The CIFs may be obliged to have such meetings where this is provided for by the current legislation of the MSs of the fund's origin. Thus, as it is indicated in the Directive 2007/36/EC on the rights of shareholders,[42] through their participation in general meetings the investors are entitled to make certain adjustments to the agenda, draft resolutions, vote on the issues under consideration or otherwise exercise their rights. However, serious restrictions on the possibility to partake in such meetings still persist. One example is the so called "share blocking" mechanism whereby an investor may be refused to attend a meeting, if the latter does not deposit their shares a few days before such meeting, either annual or extraordinary. Although this practice is explicitly prohibited in Art. 7 of the aforementioned Directive.

Moreover, many investors voluntarily opt out to participate in the relevant meetings as it implies crossing borders or even moving around

[42] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies. OJ L 184, 14.07.2007. Pp. 17–24.

the country. Despite the fact that the Directive 2007/36/EC allows electronic voting, there is no mandatory requirement to set this kind of voting out in the funds' constitutional documents, due to which many MSs of the EU have granted the power to implement this provision of the Directive to CIFs themselves. Besides, virtual meetings, within which direct interaction between investors or between investors and the members of the board of directors is carried out via information and telecommunications network called "Internet," are neither stipulated, nor prohibited by the Directive as it clarifies that the MSs are entitled to identify other forms of participation in the meetings (Wegman, 2016, pp. 159–163).

IV. Depositary and Management Company

Above all, one should point out that the Directive 85/611/EEC heavily focused on the product rather than the MC and the depositary of UCITS. The idea behind that approach was that the regulation did not allow the MC and the depositary to render transboundary services in other MSs (Buttigieg, 2014, p. 66). In other words, both of them were supposed to be formed in the UCITS home MS. This limitation is quite serious, because the establishments in question are closely correlated with retail investment performance. Thus, it is necessary to focus on their role in the financial process.

Let us examine the MC, which, above all, refers to an organization that is directly involved in decision-making about investing in assets. However, apart from this, it is responsible for adopting the fund's investment strategy, which reflects, among other things, UCITS risk assessment and management. The 1985 Directive stipulated that in order to have their business in the natural course such companies were to have a considerable amount of financial resources and were not allowed to engage in any activity other than management of CIFs.[43] This provision sought to avoid risks of a potential conflict of interests between the MC and the UCITS fund, which would have contributed to

[43] Commission of the EC. Towards a European market for the undertakings for collective investment in transferable securities: Commentary on the provisions of Council Directive 85/611/EEC. Office for Official Publications of the EC, 1988. P. 22.

unit holder protection (Turtiainen et al., 2022, p. 866). Noteworthy, the above-mentioned definition of a UCITS clearly states that this kind of establishment operates on the risk allocation principle. By way of setting minimum restrictions as to such allocation in Art. 23, 24 and 25 of UCITS I, the reasonable diversification of the undertakings' assets was guaranteed. This is deemed another conventional measure intended to safeguard the rights of retail investors. In this regard, the restrictions described hereinbefore shall warrant that the UCITS assets at the disposal of the MC are invested in a manner consistent with the objects, so as the investment policy of the establishments under consideration allowing them to mitigate the asset concentration risks.

In another attempt to attain the appropriate level of investor protection, Art. 7 and 14 of the 1985 Directive set down the requirements for entrusting assets to depositaries, entities independent from UCITS funds and MCs. Not only do they engage in safekeeping, but they also serve as a financial liaison between the fund and the investor. Being a part of the investment triangle, this establishment is tasked with restricting the MC's access to money and property of the retail investor. Moreover, UCITS I establishes two basic criteria that all those dealing with the UCITS sub-sector have to meet. On the one side, CIFs of UCITS type are to appoint an independent depositary. On the other side, the depositary is obliged to oversee the MC. In conformity with Art. 9 and 16 the depositary may incur liability for any detriment the UCITS suffered due to the failure to carry out its commitments without a good reason and the improper execution of the latter. At the same time, the Directive does not specify liability measures, meaning that the MSs could determine them on their own.

This regulation was imposed following the Investor Overseas Services, Ltd. episode in the late 1960s. Once a largest player in the US financial market, the corporation found itself mired in a securities fraud, when a legal entity in charge of the CIF's assets managed to withdraw some of them, on demand of certain individuals. On reflection, one can see that the company was nothing but a financial pyramid whose controlling parties took personal advantage of retail investments, which ultimately led to its bankruptcy.[44]

The Directive 85/611/EEC also provides for substantive disclosure requirements according to which MCs and investment firms are obligated to publish sale or issue / repurchase or redemption prices of units, a prospectus, as well as a half-yearly and annual financial report. This framework for transparency enables investors to take informed and rational decisions and diminishes the risk of getting asymmetric information which can occur whenever individual players have more important information on the subject of a contract, particularly an investment contract (Rayzberg, 2022, p. 29).

As was mentioned above, the first attempt to update the 1985 Directive was made in 1993 and 1994. Alongside the examined changes, the Commission brought forward proposals concerning the necessity to grant a European passport to depositaries. The idea was not new, conceived earlier by the Second Council Directive 89/646/EEC of 15 December 1989[45] and the Council Directive 93/22/EEC of 10 May 1993.[46] Both documents allowed credit institutions and investment firms to engage in cross-border activities according to the European passporting systems. Under such circumstances, the Commission arrived at the conclusion that the time was ripe for UCITS funds to freely choose their depositaries authorized to operate within the EU, regardless of their registered offices.

The 1985 Directive prohibited credit institutions and investment firms which rendered depositary services from doing the same in relation to UCITS funds. Consequently, the MSs with less developed depositary industries were put at a relative disadvantage. The lack of a high level of competition in this realm, firstly, led to the limited impact of national depositary service markets and, secondly, to additional costs

[44] Time. Scandals: One of the Largest Frauds. 1972. Available at: https://time.com/archive/6815833/scandals-one-of-the-largest-frauds/ [Accessed 21.12.2023].

[45] Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC. OJ L 386, 30.12.1989. Pp. 1–13.

[46] Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field. OJ L 141, 11.06.1993. Pp. 27–46.

incurred by the UCITS schemes established in the aforementioned MSs, which eventually affected the consumers of financial services. Thus, it is possible to say that the expansion of the European passport concept to depositaries was necessary to foster competition, which, in its turn, guaranteed the appropriate level of depositary services provided to UCITS structures. This would have been achieved through the increase in supply of such services, proceeding from which the funds under consideration could have benefited from the conclusion of depositary agreements suiting the undertakings' needs to the best advantage. In such cases, this frequently translates into lower prices and costs for retail investors.

One should note that the amendments of the 1994 Proposal to UCITS I were considered too ambitious by MSs. During the Council's deliberations on the matter multiple discrepancies concerning the MSs' approaches to numerous facets of the Proposal were revealed. The most controversial issues were interrelated with qualifying the previously discussed master-feeder structures as UCITS and the provision of a European passport to depositaries. Even the members of the EP eventuated in considerable controversies concerning the latter. For instance, Perreau de Pinninck, the MEP of the third parliamentary term for the Kingdom of Spain, raised certain issues correlated to the depositaries' transboundary activism.[47] Mr. Pinninck asserted that *"the Commission's Proposal to grant credit institutions and investment firms the possibility to passport depositary services on the basis that they were already authorized to provide safekeeping of assets... as confusing the function of mere safekeeping of assets with the complex role that a depositary must fulfil in relation to investment funds"* (Buttigieg, 2020, p. 591), which is a key problem, since the UCITS depositary's duties also imply, for example, monitoring the MC's actions, the fund's investment policy, etc. (Hooghiemstra, 2018, p. 37).

The comments by De Pinninck imply that the application of the mutual recognition would have required European legislators to harmonize the rules governing the duties of a depositary. At the time,

[47] European Parliament. 1993/94 session. Minutes of proceedings of the sitting of Monday, 25 October 1993. OJ C 315, 22.11.1993. P. 16.

that was not something the EU was ready to do. Apart from this, the 1994 Proposal did not contain any provisions for prudential supervision of depositaries that would have minimized systemic risks. These rules, taken together, at the same time, are portrayed as another paramount tool ensuring that the mutual recognition mechanism works properly. Given the MEP's remarks, one can conclude that he suggested that the EP should reject the very idea of granting a European passport to depositaries. In fact, the period from 1985 to 1994 saw a few tentative steps taken towards more integration in the sphere.

It should be indicated that the transparency standards stipulated by the Directive 85/611/EEC emanated from the idea that the investor had the right to access massive amounts of data before making an informed investment decision.[48] As a result, the primary purpose established by the Directive for a prospectus was that of furnishing the UCITS investors with the specific financial instrument's and issuer's particulars in order for such unit-holders to estimate whether the general characteristics of the security offered and risks associated with it correspond to their strategy.[49] Yet the average buyer of UCITS units avoided reading and scrutinizing the prospectus due to its somewhat confusing and non-understandable nature. This was confirmed by the study conducted in the United States, where similar problems occurred. It was proved that at least four years of higher education in economics were required so that the retail investor could comprehend the major portion of a prospectus (Johnson, 2004, p. 61).

Furthermore, not only did the 1985 Directive contain no detailed rules applicable to the activities of the MC and the depositary, but it also forbade the former from providing services other than the collective portfolio management, the motivation for which was to

[48] European Commission. 2006. Frequently Asked Questions (FAQs) on the White Paper on enhancing the Single Market framework for investment funds (Memo). Available at: https://ec.europa.eu/commission/ presscorner/detail/en/memo_06_431 [Accessed 21.12.2023].

[49] EFAMA. 2005. Comments on the EU Commission Green Paper on the Enhancement of the EU Framework for Investment Funds. SEC (2005) 947. Available at: https://web.archive.org/web/20060923205858/http:/www.efama.org/55PositionPapers/2005/efamacommentsgreenpaperinvestmentfunds/documentfile [Accessed 23.12.2023].

maintain the investors' rights protected by means of supporting a sufficient professional management level, so as through the obviation of the conflicts of interests. However, this was the case, which led to the Directive being construed differently on part of MSs. In this light, the 1998 UCITS MC and Prospectus Proposal looks like an attempt to eliminate the shortcomings of UCITS I. The name of the document suggests the Commission resolved to reach two goals, namely to introduce a simplified prospectus and to harmonize the requirements concerning the MCs and their cross-border activities. It seems reasonable to mention this kind of prospectus for two reasons. Firstly, it fits the purposes of our study. Secondly, it is the MC — or the investment company falling under the definition of UCITS — that is responsible for publishing this document.

The Commission's Proposal outlined a regulatory framework that would have made it easier for retail investors to digest the most important information about their potential purchase. It was quite a timely initiative, because back then, the rule to compose a simplified type of prospectus was already enforced in certain MSs. Having such provisions approximated would have resulted in the decrease of the expenses incurred by the sub-sector due to the MSs, where such type of prospectus was not introduced, not being able to impede the smooth promotion of the UCITS securities through the imposition of extra disclosure requirements.[50] This was also emphasized by the EP.[51] Interestingly enough, UCITS funds were forced by some MSs to submit a plethora of documents about the assets acquired or their internal structure.

Analyzing the simplified prospectus as a concept, it is possible to say that it was rather innovative and forward-looking. It should have improved the position of those getting access to the document before

[50] Amended proposal for a Directive of the European Parliament and of the Council amending Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses. COM (2000) 331. P. 22.

[51] Committee on Economic and Monetary Affairs. Report... A5-0025/2000. P. 37.

purchasing units. The transposition of this very new provision of the Directive 2001/108/EC of 21 January 2002[52] (Art. 21(1)) was not a cakewalk. Meanwhile, all the legislative acts passed between 1998 and 2004, including the two Directives of 2001, are referred to as "UCITS III" (Stefanini, 2015, p. 31). The bone of contention was national differences concerning the manner in which the stipulations of the Directive had to be observed during the simplified type of prospectus being prepared.

This prompted the Commission to endorse Recommendation 2004/384/EC of 27 April 2004,[53] with the aim of clarifying the presentation and content of the particular facets of the prospectus. The simplified version, therefore, was supposed to contain such points as: 1) a concise description of the outcomes sought for any investment in the UCITS, 2) the main categories of eligible investment instruments which are the objects of investment, 3) the information concerning the use of derivatives, an indication of whether this is done in pursuit of the UCITS objectives, or for hedging purposes only, 4) a brief risk profile evaluation, so as 5) the performance over a 10-year period.

Notwithstanding the clear wording of the recommendation, MSs did not adopt a consistence stance on it. It became definitely clear, over time, that the intended results of the transposition of prospectus of this form into European law were never attained. Indeed, what was conceived as a bulletin suitable for retail investors became in reality a long, legally and technically worded document too complex to be comprehended by buyers of units. The situation proved a major headache for all the parties concerned, which prepared the ground for a series of initiatives aimed at replacing the simplified prospectus. In this context, one should quote Charlie McCreevy, European Commissioner for Internal Market and Services, on the issue, *"The simplified prospectus will be*

[52] Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses. OJ L 41, 13.02.2002. Pp. 20–34.

[53] 2004/384/EC: Commission Recommendation of 27 April 2004 on some contents of the simplified prospectus as provided for in Schedule C of Annex I to Council Directive 85/611/EEC (Brussels, 27 April 2004). OJ L 144, 30.04.2004. Pp. 42–55.

reconfigured and simplified. It was meant to provide investors and intermediaries with concise and understandable information about the risks, associated charges, and expected outcomes. However, it has been sabotaged by national gold-plating and divergent implementation."[54]

As for the MCs, one should point out that over time the situation, where such companies were put at a less advantageous position compared to other financial services providers, became more and more perceptible due to the constantly increasing pace of the development of the SMFS securities sector. This was persistently condemned by the MSs and the representatives of the sub-sector, since the latter prevented the full-fledged implementation of the economies of scale, and created a hazard of unjustifiable and incoherent capital allocation between collective portfolio management and individual one.[55] The 1998 UCITS MC and Prospectus Proposal was designed to rectify the problem through granting the MCs with the authority to render certain types of auxiliary services, in particular those services which by that time were already provided for by the Investment Services Directive (ISD), and therefore had been provided by the investment firms for at least five years.

To ensure a level playing field and to protect investors, the Commission signified that, firstly, the expansion in the types of services provided by the MCs, is feasible, and, secondly, these services shall be subject to those rules and regulations that apply to investment firms, including the capital adequacy requirements set out by the Directive 93/6/EEC.[56] This is an indication that the Commission sought to prevent the onset of any possible conflicts between those rules that had already been imposed on the investment firms and the novel

[54] European Commission. 2006. Charlie McCreevy, European Commissioner for Internal Market and Services. Current issues in financial services: Investment Fund Policy. SFE Industry Lunch. (Speech, Edinburgh, 20 November 2006). Available at: https://ec.europa.eu/commission/presscorner/detail/en/speech_06_707 [Accessed 25.12.2023].

[55] Proposal for a European Parliament and Council Directive Amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS) with a View to Regulating Management Companies and Simplified Prospectuses. COM (1998) 451. P. 5.

[56] Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions. OJ L 141, 11.06.1993. Pp. 1–26.

provisions concerning the types of services rendered by the MCs. Thus, the analyzed 1998 Proposal recommended to encompass a list of such activities. Annex 2, which contains the aforementioned list, stipulated that only 14 types of services may be rendered by the MCs, but not all of them were eventually covered by the Directive. Hence, the following list of services made its way into the final text of the Directive: accounting services, income distribution, record keeping, etc.

Additionally, the MC should be granted the right to devolve a certain portion of its tasks (for more efficient organization of its operations) provided that its home financial supervisor gave the green light to that. The pertinent stipulation of the 1998 Proposal caused much debate at a supranational level. Take, for instance, the EESC which justified its position by explicating that MCs in some MSs were legally obliged to keep accounting records of the funds' transactions, while in others this mission could be entrusted to third parties. Moreover, the established system offered a favorable climate for the MCs' industry at the national level, all of which actually meant that there were no grounds for the introduction of a legal regulation at the European level.[57] The EP drew similar conclusions, highlighting that the rule necessitating the MCs to be preliminary approved by the national supervisor before the delegation of some of their powers would lead to a bureaucratization of the process.

All this prompted the Commission in 2000 to make certain modifications to its Proposal, which superseded the aforesaid requirement with the rule specifying that the MCs must submit all necessary information regarding the outsourcing of some of their functions to the national competent bodies in order to maintain the continuity of supervisory activities, but the advance notification of such authorities was excluded. Nevertheless, the institution insisted upon the necessity to devise the criteria that would allow the MC would have to satisfy to be able to delegate some of its powers. This was reflected in the Directive 2001/107/EC (Art. 5g(1)).

[57] Opinion of the Economic and Social Committee on the "Proposal for a European Parliament and Council Directive amending Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses." OJ C 116/1, 28.04.1999. P. 3.

As far as the European passport is concerned, the Proposal likened the MC to other service providers that had already been passported, namely investment firms and credit institutions that could perform functions similar to those of MCs. Such authorization would have allowed the entities in question to have their services rendered across the Union. This would have boosted the free movement of services because MCs would have been entitled to establish their branches in host MSs under the simplified procedure. The experience and expertise acquired after the transposition of the ISD were in favor of the Commission advocating for the creation of a legal regime, whereby the companies under consideration could have been authorized. It is particularly remarkable that the Proposal articulated the necessity to passport MCs exclusively in those MSs, where such companies carried out the major portion of their activities.[58] This recommendation was incorporated into Art. 5(1) of the Directive 2001/107/EC.

Interestingly enough, not all the parties concerned were outspoken in their support for the MC's passport. For instance, some representatives of the sub-sector believed that enabling MCs to function in host MSs could substantively vary from the UCITS permission on the same issue, which would inject the uncertainty into the market, i.e., potential risks could exceed and outweigh the benefit received. The most vociferous opponents of the Commission's approach were companies based in Luxembourg.[59]

The problem was also discussed by the CESR, thinking that, *"The legislator's intention does not seem to have been to impose to UCITS home Member States to recognize the possibility for a foreign management company to set up an investment company in their own*

[58] Proposal for a European Parliament and Council Directive Amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS) with a View to Regulating Management Companies and Simplified Prospectuses. COM (1998) 451. P. 7.

[59] CESR. ALFI contribution to the CESR consultation paper on UCITS management company passport. CESR/08-748. Available at: https://www.esma.europa.eu/file/8101/download?token=cv34X437 [Accessed 27.12.2023].

constituency."[60] Although the statement seems bizarre, CESR members remained committed to the imperative of designating a MC in the same MS of the Union as that of UCITS scheme. Such a state of affairs exemplifies that in some cases the promotion of national interests coupled with the call for protectionism can undermine the European integration within the sub-sector. The view which partially diminished the prospect for the MC passport was challenged by the promulgation of the Directive 2001/107/EC. The organizations could not enjoy the benefits of the passporting system, albeit with some limitations.

Apart from this, the EESC again brought up the depositary passport issue, highlighting its paramount importance in the industry and suggesting that the Commission should explore the ways of how to extend passporting rights to depositaries while ensuring adequate regulatory supervision.[61] Perhaps at the initial stages of development of the sub-sector, there was some political rationale behind the preservation of the requirement as to the depositaries being compelled to get established in the same MS as UCITS, but in the course of the SMFS development, the failure to impart the passporting system to depositaries was regarded as a malfunction or, at least, as a discrepancy between the regulatory regime and the economic realities of that time, which eventually affected the UCITS investors. The EESC's position seemed to have come home to the Council, because while preparing the overall stance on the enactment of the two Directives of 2001, the latter requested the former to lodge a review on the governance of the depositaries' activities.[62] The Commission's work in the field was still ongoing.

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[60] CESR's guidelines for supervisors regarding the transitional provisions of the amending UCITS Directives (2001/107/EC and 2001/108/EC), February 2005. CESR/04-434b. P. 9.

[61] Opinion of the Economic and Social Committee on the "Proposal for a European Parliament and Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertaking for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses." OJ C, C/116, 28.04.1999. P. 3.

[62] Communication from the Commission to the Council and to the European Parliament Regulation of UCITS depositaries in the Member States: review and possible developments (Brussels, 30.03.2004). COM (2004) 207.

Thus, UCITS III constituted an attempt to grant a European passport to MCs. At that point, the national competent authorities did not find it reasonable to permit such entities to engage in cross-border activities. However, as was mentioned earlier, MCs were finally authorized to provide some services across the Union, which points to the concept of a European passport having been de facto valid since 2001.

In 2008, the Commission requested that the CESR should come up with its recommendations on giving more rights to MCs. The Committee responded in October,[63] advocating in favor of the delineation of the responsibilities concerning the supervision of the MCs' activities of the home and host MSs. Noteworthy, the package of proposals entailed that the Union's supervisory authorities would conclude bilateral or multilateral agreements, which could address difficulties arising from mutual mistrust and even trigger the creation of the single board for financial supervisory authorities. Unfortunately, no progress has been made towards the latter.

Generally speaking, the regulatory framework laid down by UCITS IV reflected the CESR's advice. Finally, it introduced the MC passport, thus allowing such businesses to render their respective services within the SMFS or to establish their offices in the host MSs. At the same time, authorization may exclusively be bestowed by those MSs where both the registered and head offices of a MC are located, that is to say, the approval of its application to perform the transboundary activities by the home MS's supervisory bodies may not exceed six months (Loesch, 2018, p. 245). In order to obtain admission to the Union's internal market, the MC, which has announced its intention to pursue its respective activities in other MSs, commits itself to informing its home financial supervisor about this. Under Art. 18(1) of UCITS IV, the information required includes the MS where the MC intends to run business and an action program specifying the risk management process. However, the company may be able to perform its scheduled business activities approximately after one month, when the data provided to

[63] CESR's advice to the European Commission on the UCITS Management Company Passport, October 2008. CESR/08-867.

the authorized bodies of the home will be actually transferred to the regulatory authorities of the host. Despite the fact that the Directive also enables MCs to delegate some of the powers to the organizations registered beyond the Union, they are obligated to retain the significant part of them. Looking at Art. 13, one may assume they are liable for the work done by other organizations (Loesch, 2018, p. 246).

Moving on to the issue of supervising MCs, most of the powers reside in their home competent authorities, because Art. 19 of UCITS IV sets forth that the companies have to conform with the exigencies of the MS of the undertaking's origin. According to Art. 21, any breaches identified by the host MS's competent bodies tend to be communicated to the supervisory bodies of the MC's home MS. Yet, in case where the MC's location is in a different MS, it shall abide by the norms of such country as to the passporting of funds, investment policies, limits, etc. The Directive also holds that the requirements the MC has to satisfy at a national level and those which the same MS imposes on MCs authorized in that MS should be equivalent to each other.

Regarding depositaries of UCITS schemes, one can unfortunately state that they still cannot enjoy the benefits of passporting. The requirement that the depositary of EU domiciled investment has to be set up in the home MS where the investment fund is established has been relevant since the 1985 Directive. It remains unclear why this approach dominates the EU. Some believe that it stems from the aspiration of certain MSs to retain control over the depositary market, so as from the plausible distrust between MSs concerning the national supervisory powers for the integrity of a depositary market (Buttigieg, 2020, p. 593). The issue was pushed to the forefront of public debate[64] organized by the Commission in 2012. Having analyzed 97 responses, the body witnessed some public reluctance to embrace the idea, as the majority of advantages depositary passporting are rather hypothetical (Buttigieg, 2020, p. 593). Such feedback seems pretty awkward, especially given the long integration period in the UCITS sphere.

[64] European Commission. Consultation Document. "Undertakings for Collective Investment in Transferable Securities (UCITS). Product rules, Liquidity, Management, Depositary, Money Market Funds, Long-term Investments." (Brussels, 26 July 2012). B-1049.

Since UCITS IV came into force, there has been no significant progress towards finding the solution to the problem. However, based on the 2012 consultations, the Commission put forward another Proposal,[65] which was followed by the adoption of the Directive 2014/91/EC of 23 July 2014 two years later.[66] Sometimes described as UCITS V (Alshaleel, 2016, p. 14), the new Directive concentrated on the depositary. More specifically, certain provisions concerning their liability before UCITS funds and investors were clarified. As it was before, the depositaries are responsible for losses incurred by UCITS, which may arise due to the depositaries' failure to fulfil their obligations or their improper performance. The wording "improper performance" turned out to be another apple of discord, which led to different national interpretations and levels of investor protection. Despite the title of the 2014 Directive, European legislators failed to harmonize the liability-related measures but defined the cases when the depositary may be found liable to UCITS and their investors.

Article 24(1) confers responsibility on the depositary, where 1) the financial instruments, which may be actually deposited, and 2) all other types of assets, such as OTC derivatives, which are subject to record keeping and ownership verification duties, were lost. The forfeiture of the former type makes the depositary liable, unless it can substantiate that such loss occurred due to some events beyond reasonable control (Alshaleel, 2016, p. 19). According to Art. 26b, such cases are determined by the Commission. When it comes to the loss of the latter, the depositary will be liable to the UCITS and its investors only if the situation happened as a result of its negligent or intentional failure to fulfil its obligations in a proper manner. Looking at these two points,

[65] Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions. COM (2012) 350.

[66] Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions. OJ L 257, 28.08.2014. Pp. 186–213.

the following conclusion arises. The legal regime set forth nowadays is indubitably inclined towards harmonization of depositary activity, thus, translating into greater supervisory convergence, which was the key idea behind the 2012 consultations.

V. Conclusion

With UCITS I coming into full effect in 1989, the SMFS saw the emergence of the UCITS sub-sector. From our perspective, the introduction of a passport based on the mutual recognition mechanism constituted the most remarkable achievement of European legislators at the time. It opened up opportunities for financial consumers to invest in the relatively low-risk securities. Indeed, the entire regulatory framework for UCITS is designed to fully safeguard non-institutional investors who are often lacking in relevant experience and expertise, which accounts for its credibility. Undoubtedly, when the legal mechanism governing the funds was in its infancy, one could face a plethora of obstacles to mutual recognition mechanism in the form of inconsistent interpretations of the Directive or the mixed results of its transposition. UCITS II was intended to address all those problems, including through the establishment of depositary passporting, but MSs, in pursuit of their national interests, prevented the document from being passed into law.

Although the Directive 85/611/EEC was generally ahead of its time, a variety of restrictions contained in its text can be called too tight, especially against the background of the fast-paced financial market. That was the very reason why the Commission had been vigorously pursuing the policy of encouraging investment in CIFs, launching different legislative initiatives which did not always resonate with the EP and the Council. Let us remind you that the opposition to the 1994 Proposal at the Council and the EP level kept in place the mutual recognition restrictions stipulated by the 1985 Directive for 16 years.

One can thus conclude that in the beginning the formation of the UCITS sub-sector was compounded by inter-institutional and interstate controversies. This produced the requirements which gave MSs considerable latitude in interpreting the provisions of the documents and badly affected uniform implementation of European legal norms and rules at a national level. It was fiendishly difficult for MSs to find the common ground, because at the time they were preoccupied with their own financial markets and reluctant to surrender some part of their financial authority to the supranational organization.

With every new regulation controlling UCITS, European legislators sought to expand the scope of communitarian rules. For example, the second generation of the UCITS Directive envisaged granting a European passport to depositaries and designating funds of funds, cash funds and money market funds as belonging to UCITS. Notwithstanding that the former was considered a necessary step to stronger competition in the depositary industry, it became subject to much dispute and debate among MSs adhering to their protectionist policies. Consequently, UCITS II was never adopted. Moving on to the two Directives of 2001, it is possible to say that their implementation was crucial to further financial integration, because they contained the provisions regarding, say, the longer list of permissible instruments, the MC passport, and the simplified prospectus.

In spite of the fact that financial integration was influenced by external factors, e.g., the 2008 crisis, the resulting regulatory framework stipulated by UCITS IV demonstrates that even amid the economic shocks, European legislators managed to strike a balance between the interests of MCs and depositaries, on the one hand, and the interests of supervisory authorities of MSs, UCITS and their investors, on the other hand. They also managed to reconcile the differences, at least for some time, between the Union and its MSs. However, some issues, including giving depositaries access to passporting system, have yet to be resolved. Certain steps have already been taken towards the resolution.

Thus, the legal framework for UCITS is aimed at protecting the rights of retail investors. For almost four decades, the effective mechanisms for the implementation of such protection have been designed, in particular, the rights of the corporate funds' shareholders at investor meetings have been secured, various means of enhancing competition within the sub-sector and avoiding the risk of a conflict of interest have been enshrined, the necessity to resort to depositary has been preconditioned, etc. Despite the fact that a number of legislative gaps not allowing to consider the system for the protection of investors indubitably perfect remain, say, the limitations of the mutual recognition mechanism, the Commission itself acknowledges that the EU acts governing UCITS activities in their entirety constitute a part of the Union's *"acquis on retail investor protection."*[67] Therefore, almost the 40-year-long development of the legal framework applicable to UCITS can be summed up in the table below.

Directive	Achievements
UCITS I	— Establishment of the UCITS sub-sector as part of the SMFS; — Introduction of uniform minimum requirements the parties concerned must comply with; — Provision of a European passport for UCITS
UCITS II	Never adopted
UCITS III	— Expansion of the types of UCITS schemes; — Introduction of a European passport for MCs; — Adoption of the simplified prospectus
UCITS IV	— Expansion of the UCITS eligible funds; — Extension of the rights of MCs (in fact, full exercise of rights stipulated by the European passport)
UCITS V	Identification of depositary liability cases

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[67] Commission Staff Working Document. Impact Assessment Report Accompanying the document Proposal for a Directive of the European Parliament and of the Council amending Directives (EU) 2009/65/EC, 2009/138/EC, 2011/61/EU, 2014/65/EU and (EU) 2016/97 as regards the Union retail investor protection rules and Regulation of the European Parliament and of the Council amending Regulation (EU) No. 1286/2014 as regards the modernization of the key information document. SWD/2023/278. P. 6.

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