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The Inadequacy of the UCITS Directive in a Global Marketplace

I. INTRODUCTION

Collective investment funds are vehicles that pool investors' money for the purpose of investing in securities.¹ These funds have become an increasingly important means for investors to attain diversification of investment opportunities, economies of scale² and professional management of their investment capital.³ The emergence of an international market for professional asset management has made foreign investment companies more attractive to investors who wish to further diversify their portfolios through investment in foreign securities.⁴

In 1985, the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS Directive) was adopted in the European Community⁵ to coordinate laws and regulations for collective investment undertakings in order to encourage international investment within the EU.⁶ A UCITS is a European fund where investors' money is placed by a qualified manager in a diverse range of assets according to defined risk criteria.⁷

Prompted by existing barriers⁸ to the free cross-border marketing of units issued by UCITS and inadequate investor protections, the European Commis-

1. See Clifford E. Kirsch, Practicing Law Institute, *Nuts and Bolts of Financial Products: An Introduction to Mutual Funds*, 975 PLI/CORP 239, 246 (1997).

2. Economies of scale are reductions in average and marginal costs that result from the increased size of an operating unit. See SHLOMO MAITAL, EXECUTIVE ECONOMICS: TEN ESSENTIAL TOOLS FOR MANAGERS 120 (1994).

3. See UNITED STATES SECURITIES AND EXCHANGE COMMISSION, DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION, xvii (1992) (SEC REPORT, PROTECTING INVESTORS).

4. See generally *id.* at xx.

5. The Maastricht Treaty established the European Union, which is founded on the three European Communities (collectively amended to the term European Community). See TREATY ON EUROPEAN UNION, Feb. 7, 1992, O.J. (C 340) 145 (1997) (consolidated version incorporating the changes made by the Treaty of Amsterdam). The Treaty of Paris establishing the European Coal and Steel Community (ECSC) (1951), the Treaties of Rome establishing the European Economic Community (EEC) and the European Atomic Energy Community (Euratom) (1957), as amended by the Single European Act (1986), the Maastricht Treaty on European Union (1992) and finally the Amsterdam Treaty (1997), form the constitutional basis of the Union. See Pascal Fontaine, *Europe in Ten Points*, at http://europa.eu.int/comm/dg10/publications/brochures/docu/10lecons/txt_en.html.

6. Council Directive 85/611/EEC of December 20, 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS Directive), 1985 O.J. (L 375) 3, 4.

7. See *Financial Services: Amended Commission Proposals to Improve and Extend Rules on Collective Investment Undertaking (UCITS)*, at http://europa.eu.int/comm/internal_market/en/finances/mobil/2k-567.htm. UCITS are discussed in greater detail in part III of this note.

8. Previously, the scope of allowable investments of UCITS was limited to stocks and bonds and a rapidly changing financial environment had presented a need to update how UCITS can be managed. See *id.* This is discussed in greater depth in part III of this note.

sion⁹ proposed to amend the UCITS Directive in May 2000.¹⁰ The Council of the European Union subsequently approved the proposed amendments in October 2000 and March 2001.¹¹ The amendments remove barriers to cross-border marketing of funds by expanding the range of assets in which a UCITS may invest.¹² Additionally, the amendments harmonize rules on market access, operating conditions, and prudential safeguards throughout the European Union.¹³ A number of new safeguards have been implemented to protect the interests of individual and institutional investors.¹⁴ The new framework is designed to achieve a high level of protection for investors by setting standards for both the investment products and the managers of the investment.¹⁵

In order to facilitate marketability, regulations governing cross-border collective investment schemes generally must be drafted so as not to discriminate against non-domestic companies, while at the same time they must adequately ensure investor protection.¹⁶ Prior regulation of collective funds among EU member states drastically varied.¹⁷ EU member states took different approaches to regulating access to the UCITS market by investment companies and the operating conditions imposed on those companies.¹⁸ The amendments to the UCITS Directive are therefore intended to create a level playing field in the European investment fund industry, thereby reducing legal uncertainties and helping to stabilize the European financial system generally.¹⁹ Similar to the United States' scheme for regulating investment companies, however, the UCITS Directive continues to impede globalization of the securities industry. Further legislative reform is necessary to encourage

9. The Council of the European Union and the European Parliament jointly enact Union legislation. *See* Fontaine, *supra* note 5. The Council adopts international agreements negotiated by the Commission. *Id.* The Commission has the power to intervene at any stage in the legislative process to facilitate agreement within the Council or between the Council and Parliament. *Id.* The Commission also ensures that the regulations and directives adopted by the Council are properly implemented. *Id.*

10. *See Financial Services: Amended Commission Proposals to Improve and Extend Rules on Collective Investment Undertaking (UCITS)*, *supra* note 7.

11. *See European Fund Companies Gain Flexibility*, Mutual Fund Market News, March 26, 2001.

12. *See EC Proposes New Rules to Encourage Cross-Border Sale of Collective Funds*, World Securities Law Report, June, 2000, at 5.

13. *See generally Financial Services: Amended Commission Proposals to Improve and Extend Rules on Collective Investment Undertaking (UCITS)*, *supra* note 7.

14. *See* EUR. PAR. DOC. (COM 2000) 331, explanatory memorandum, at 6-10.

15. *See Financial Services: Commission Welcomes Political Agreement on Investment Fund Management Directive*, at http://europa.eu.int/comm/internal_market/en/finances/mobil/01-345.htm.

16. *See generally* MARC I. STEINBERG, INTERNATIONAL SECURITIES LAW A CONTEMPORARY AND COMPARATIVE ANALYSIS 302 (1999).

17. *See* EUR. PAR. DOC. (COM 2000) 331, explanatory memorandum, at 6.

18. *See generally id.*

19. *See id.* The amendments to the UCITS Directive are merely one aspect of an action plan designed to improve the functioning of a single market in the European Union. *See generally* Communication of the Commission of the European Council, Action Plan For the Single Market, CSE(97)1 final.

greater international acceptance of foreign investment funds throughout the world.

Part II of this note will analyze relevant principles for regulating collective investment schemes and will conclude with a discussion of current issues in harmonizing investor protection standards under foreign law. Part III will highlight the legislative overview of the UCITS Directive and the European Commission's amendments, extending the rules on collective investment undertakings. Part IV will focus on the Securities and Exchange Commission's position on cross-border collective investment schemes and investor protections through the Investment Company Act of 1940. Part V will identify weaknesses in the UCITS Directive. Part VI concludes that while the amendments to the UCITS Directive work to facilitate the success of the European Community's internal market in UCITS, further legislative reform is necessary both within and outside the European Union to allow agreements to be reached among foreign nations in order to encourage globalization of a market in collective investment funds.

II. PRINCIPLES FOR REGULATING COLLECTIVE INVESTMENT SCHEMES

The main objectives of securities regulation are to protect investors,²⁰ reduce systemic risk and ensure the efficiency, fairness and transparency of financial markets.²¹ To achieve these objectives in the context of investment funds, specialized regulatory guidelines are needed.²² To the extent that the market for individual stocks and bonds is efficient, investors take advantage of information processing done by the market to ensure a fair price.²³ Because investors in collective funds are purchasing shares in baskets of securities, the market is not available to ensure that a fund's shares are efficiently priced.²⁴ The assets of actively managed funds are constantly changing and the market in collective funds is not continuously evaluating each fund's sales load, operating expenses, and other costs against the relative expertise of the fund manager.²⁵ Thus, effective regulatory guidelines for collective investment schemes are crucial to the objective of investor protection and should ensure that investors have access to a fair market.²⁶

To guarantee that investors are protected from fraud and unfair treatment, a regulatory system must impose high standards on the eligibility of operators

20. Securities regulations provide investors with specific protections against self-dealing, conflicts of interest, misappropriation of funds, and overreaching with respect to fees, expenses and undisclosed risks of many types. See SEC REPORT, PROTECTING INVESTORS, *supra* note 3.

21. See STEINBERG, *supra* note 16, at 292.

22. See generally Henry T. C. Hu, *Illiteracy and Intervention: Wholesale Derivatives, Retail Mutual Funds, and the Matter of Asset Class*, 84 GEO. L. J. 2319, 2372.

23. See *id.*

24. See generally *id.*

25. See *id.*

26. See STEINBERG, *supra* note 16, at 309.

of collective investment funds.²⁷ Additionally, rules should be implemented that govern the structure of such funds.²⁸ These rules must govern the competence, honesty and integrity, financial capacity, and specific powers and duties of operators of investment funds.²⁹ Supervision of fund operators by competent regulatory agencies will ensure that the operators comply with the regulations in the interest of shareholders.³⁰ The legal structure of collective investment funds must also be regulated and supervised to ensure that investors' capital is invested in accordance with a fund's investment objectives and must require that investors' funds be segregated from other assets of the investment company.³¹

An effective regulatory system should guarantee that accurate disclosure of material information is available to investors.³² Adequate disclosure promotes accurate analysis of securities held by a fund. Accurate investment analysis, in turn, promotes the efficiency of financial markets, which allows for more optimal allocation of a nation's capital resources.³³ Disclosure about the composition of funds informs investors of the nature of the particular investment and the relationship between risk and return among the assets of the fund.³⁴ According to the Securities and Exchange Commission (SEC), "the growth of the fund industry and the diversity of fund investors warrant a new approach to fund disclosure that will offer more choices in the format and amount of information available about fund investments."³⁵ Modified disclosure requirements for collective investment funds helps prevent unsophisticated investors from being exploited.³⁶

In order to facilitate the international marketing of collective investment funds, countries must cooperate with foreign counterparts and permit mutual recognition of investment company regulations. This can be accomplished through bilateral and multilateral agreements between countries.³⁷ With the increasing globalization of financial markets, regulatory agencies must establish a framework by which information can be shared internationally.³⁸ Coupled with technological advances in communications, the expansion of the financial markets would likely open up greater opportunities for fraudulent

27. *See id.* at 310.

28. *See id.*

29. *See id.*

30. *See generally id.*

31. *See generally id.* at 310-311.

32. *See id.* at 311.

33. *See* Stephen E. Roth & Mary Jane Wilson-Bilik, Simplified Disclosure for Mutual Funds and Variable Insurance Products: Recent SEC Initiatives, SD23 ALI-ABA 307, at 310 (1998).

34. *See* STEINBERG, *supra* note 16, at 311.

35. *See* Investment Company Act Release No. 23065, 63 Fed. Reg. 13968 (March 23, 1998).

36. *See* Hu, *supra* note 22, at 2372.

37. *See* STEINBERG, *supra* note 16, at 303.

38. *See generally id.* at 302.

and other illegal activity.³⁹ Thus, international cooperation is also necessary to assist the enforcement and investigative functions of regulatory bodies.⁴⁰ With a goal toward protecting investors, reducing systemic risk and ensuring the efficiency, fairness and transparency of markets, international agreements and close cooperation among nations can help resolve these issues.⁴¹

III. REGULATION OF COLLECTIVE FUNDS IN THE EUROPEAN UNION

A. Overview of the Pre-Amended UCITS Directive

A UCITS is a collection of pooled investments organized into a fund in which investors deposit money. The money is professionally managed and invested in transferable stocks or bonds.⁴² A UCITS is essentially the European equivalent to the United States' mutual fund.⁴³ The objective of a UCITS is to raise capital from the public and spread investment risk.⁴⁴ The UCITS Directive applies only to open-end funds, defined as those whose shares may be redeemed at the request of holders.⁴⁵ Under the Directive, a UCITS is required to publicize redemption and purchase prices at the time of each transaction and at least twice a month.⁴⁶

1. The UCITS Directive's Single-License Approach to International Trade

The creation of pooled investment funds has created a means by which investors can easily diversify their investment holdings at a reduced cost while providing industries greater access to capital.⁴⁷ The potential for protecting against country-specific risk, in turn, has created a market for international investment in funds such as UCITS.⁴⁸ The UCITS Directive was enacted in order to facilitate the marketing of UCITS across borders of European countries.⁴⁹ The presence of domestic regulations has historically posed an impediment to international cooperation in the marketing of UCITS and other collective investment funds.⁵⁰ Under the UCITS Directive, when the authorities of its home member state have authorized a UCITS, the authorization is valid for all other member states throughout the European Union without the need for additional authorization.⁵¹ When a UCITS seeks to market its shares

39. See generally *id.*

40. See generally *id.*

41. See *id.* at 303.

42. UCITS Directive, *supra* note 6, 1985 O.J. (L 375) 3.

43. See MATTHEW BENDER, SECURITIES LAW TECHNIQUES § 60.02, n.3 (2000).

44. See UCITS Directive, *supra* note 6, art. 1, 1985 O.J. (L 375) at 5.

45. See UCITS Directive, *supra* note 6, arts. 2 and 37, 1985 O.J. (L 375) at 16; see Clifford E. Kirsch, *supra* note 1.

46. See UCITS Directive, *supra* note 6, art. 34, 1985 O.J. (L 375) at 15.

47. See SEC REPORT, PROTECTING INVESTORS, *supra* note 3, at xx (1992).

48. See generally *id.*

49. See generally UCITS Directive, *supra* note 6, 1985 O.J. (L 375) at 4.

50. See STEINBERG, *supra* note 16, at 302.

51. See UCITS Directive, *supra* note 6, sec. II, 1985 O.J. (L 375) at 6.

in a member state other than the one in which it was created, it must inform the authorities of its home state and also the authorities of the host state.⁵²

The UCITS Directive's single license approach to marketing funds sets forth minimum standards to which a UCITS must adhere.⁵³ The UCITS Directive generally permits a member state to impose more stringent requirements on a UCITS operating within its borders than is otherwise required by the Directive.⁵⁴ A UCITS must comply with the laws, regulations and administrative provisions of host states that are not governed by the UCITS Directive.⁵⁵ Member states are required to designate competent authorities to enforce the provisions of the UCITS Directive.⁵⁶ The designated authorities within member states are granted all powers necessary to fulfill their requirements under the Directive and must collaborate with the authorities of other member states.⁵⁷ If a UCITS is denied authorization in a member state, the authorities must provide the applicant with reasoning for the denial.⁵⁸ Any decision taken by the authorities with respect to the UCITS Directive is subject to review by the courts.⁵⁹ Unless a violation involves a requirement of a host state that is not governed by the Directive, only the home member state where a fund is authorized may take action against a UCITS for infringement of a law, regulation, administrative provision, fund rule, or investment company instrument of incorporation.⁶⁰

2. Regulations Governing the Structure of UCITS

The UCITS Directive outlines specific provisions regarding the form of funds that must be enforced by EU member states.⁶¹ The investments of a UCITS fund may only consist of transferable securities that have been admitted to an official stock exchange in a member state or dealt on a regulated market in a member state or, if approved by the competent authorities, in a non-member state.⁶² To ensure that a UCITS undertaking operates on the principle of risk spreading, it is generally required to invest no more than five

52. See *id.* art. 46, 1985 O.J. (L 375) at 17.

53. *Id.* 1985 O.J. (L 375) at 4.

54. See *id.* art. 44, 1985 O.J. (L 375) at 17.

55. *Id.* The primary areas not governed by the UCITS Directive involve marketing, advertising, and tax laws. See Investment Company Act Release No. 17534, 55 Fed. Reg. 25322, 25326 (June 21, 1990).

56. See UCITS Directive, *supra* note 6, art. 49, 1985 O.J. (L 375) at 18.

57. See *id.* art. 50, 1985 O.J. (L 375) at 18.

58. *Id.* art. 51, 1985 O.J. (L 375) at 19.

59. *Id.* The Court of First Instance has jurisdiction, subject to further appeal to the Court of Justice on points of law, to deal with disputes between the Commission and individuals or businesses as well as disputes against the Commission and administrative disputes within the institutions between the Community and its staff. See Fontaine, *supra* note 5. The Court of Justice, which sits in Luxembourg, ensures that Community law is interpreted and implemented in line with the Treaties. See *id.*

60. See UCITS Directive, *supra* note 6, art. 52, 1985 O.J. (L 375) at 19.

61. *Id.* sections III and IV, 1985 O.J. (L 375) at 6-10.

62. *Id.* art. 19, 1985 O.J. (L 375) at 10.

percent of its assets in securities issued by the same body.⁶³ Furthermore, management companies may not acquire shares carrying voting rights which would allow them to significantly influence management of an issuing corporation.⁶⁴ A UCITS generally may not borrow capital unless authorized by a member state, and in such a case, it is limited to borrowing up to fifteen percent of the borrower's assets.⁶⁵ In addition, a UCITS may not lend money or act as a guarantor on behalf of third parties.⁶⁶ To ensure qualified management, a UCITS will not be authorized unless the directors of the management company are of sufficiently good repute and have the experience necessary to perform their duties.⁶⁷

While the overall European fund industry has been growing, the cross-border marketing and operation of UCITS is still not fully integrated.⁶⁸ Of the small number of funds that operate across borders, the market is dominated primarily by UCITS originating from Luxembourg.⁶⁹ The major obstacle to free cross-border trade of UCITS throughout the EU has been the difficulty of marketing shares in host states.⁷⁰ In response, the European Council, in June 1997, endorsed the Commission Action Plan for the Single Market, which

63. *Id.* art. 22, 1985 O.J. (L 375) at 11. The UCITS Directive was amended on March 22, 1988 in response to Danish concerns over limitations that article 22 placed on the investment of UCITS assets in transferable securities. Council Directive 88/220/EEC of 22 March 1988 Amending, as Regards the Investment Policies of Certain UCITS, Directive 85/611/EEC, 1988 O.J. (L 100) 31. The Amended Directive added two paragraphs to article 22 of the UCITS Directive:

4. Member States may raise the limit laid down in paragraph 1 [5% of UCITS assets invested in transferable securities issued by the same body] to a maximum of 25% in the case of certain bonds when these are issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders. In particular, sums deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest. When a UCITS invests more than 5% of its assets in the bonds referred to in the first subparagraph and issued by one issuer, the total value of these investments may not exceed 80% of the value of the assets of the UCITS.

5. The transferable securities referred to in paragraphs 3 and 4 shall not be taken into account for the purpose of applying the limit of 40% referred to in paragraph 2. The limits provided for in paragraphs 1, 2, 3 and 4 may not be combined, and thus investments in transferable securities issued by the same body carried out in accordance with paragraphs 1, 2, 3 and 4 shall under no circumstances exceed in total 35% of the assets of an UCITS.

Id. art. 1, 1988 O.J. (L 100) 31.

64. See UCITS Directive, *supra* note 6, art. 25, 1985 O.J. (L 375) at 12-13.

65. *Id.* art. 36, 1985 O.J. (L 375) at 15-16.

66. *Id.* art. 41, 1985 O.J. (L 375) at 16.

67. *Id.* art. 4, 1985 O.J. (L 375) at 6.

68. See Christopher B. Bernard, *Note: Towards an International Market in Mutual Funds*, 36 Va. J. Int'l L. 467, 489 (1996).

69. See *id.*

70. See *id.*

highlighted the importance of completing the integration of collective investment undertakings into the EU's cross-border financial services sector.⁷¹ The Single Market Action Plan outlines priority actions that are necessary to improve the functioning of a single financial market coinciding with the introduction of the euro.⁷² Priorities of the Action Plan include making common rules more effective through enforcement, removing market distortions that result from anti-competitive behavior and tax barriers, removing sectoral barriers to market integration, and enhancing social dimensions of the single market for the benefit of citizens.⁷³

B. EC Amendments Improving and Extending the UCITS Directive

In an effort to eliminate cross-border barriers to investment in unit trusts, mutual funds, and similar collective investment vehicles, the Council of the European Union approved two related amendments to the UCITS directive in October 2000 and March 2001.⁷⁴ The first amendment focuses on the investment fund itself while the second focuses on the financial intermediary which manages the UCITS.⁷⁵ With the recent explosion of interest in Europe's financial markets, the amendments are intended to "tackle the remaining obstacles preventing the collective investment market from being fully developed across the EU while ensuring a high guarantee of investor protection."⁷⁶

As a result of the 1985 adoption of the UCITS Directive, collective investment funds have been established in all EU member states and represent more than 35 percent of the EU's gross domestic product.⁷⁷ The single license regime of the UCITS Directive, however, has been limited to investment in stocks and bonds.⁷⁸ Additionally, the single license regime was available only to banks, investment firms and insurance companies.⁷⁹ The two amendments address the limitations of the UCITS Directive and reinforce a minimum level of investor protection.⁸⁰

1. The First Amendment

The objective of the first amendment is to extend the scope of investments permitted by the UCITS Directive.⁸¹ In addition to stocks and bonds, the amendment allows UCITS to invest in money market instruments, bank

71. See EUR. PAR. DOC. (COM 2000) 331, explanatory memorandum, 2-3.

72. See *Update on the Single Market – Action Plan sets Agenda*, at http://europa.eu.int/comm/internal_market/en/update/action/plan.htm.

73. See *id.*

74. See *European Fund Companies Gain Flexibility*, *supra* note 11.

75. See *Financial Services: Amended Commission Proposals to Improve and Extend Rules on Collective Investment Undertaking (UCITS)*, *supra* note 7.

76. *Id.* (quoting European Union Internal Market Commissioner Frits Bolkestein).

77. See *id.*

78. See *id.*

79. See *id.*

80. See generally EUR. PAR. DOC. (COM 2000) 329, explanatory memorandum, at 3.

81. See *id.* at 4.

deposits (cash funds), units of other open-end collective investment funds (funds of funds), standardized financial futures, and options traded on regulated markets.⁸² The extension of the single license to a broader range of investments will encourage cross-border activity by offering greater opportunities to the UCITS industry and more choice to investors.⁸³

Another aspect of the amendment will allow greater flexibility in the proportion of individual assets held by a fund. UCITS will now be permitted to replicate the composition of stock indices that meet certain conditions that have been verified by the competent authorities of the member state where a UCITS operates.⁸⁴ The prior five percent limit on the volume of fund assets permitted to be invested in a single security limited the ability of UCITS to track certain market indexes.⁸⁵ More flexible risk-spreading requirements should facilitate the replication of such indices.⁸⁶ The amendment requires replicable stock indices to be periodically published by the European Commission in the Official Journal of the European Communities.⁸⁷ In addition to the minimum standards prescribed by the amendment, member states are permitted to define the regulation of UCITS by stipulating stricter or additional requirements.⁸⁸

2. The Second Amendment

The second amendment focuses on strengthening the European Union's internal market in UCITS by aligning the regulation of management companies with that of other operators in the financial services industry.⁸⁹ Operators of management companies may now benefit from the single license regime when authorized in a member state, similar to banks, investment firms and insurance companies under the prior UCITS Directive.⁹⁰ The home country that authorizes a management company will continue to have jurisdiction over supervisory and regulatory functions and the host country will still control the marketing, advertising and tax consequences of investment in UCITS.⁹¹

82. *See id.* at 5.

83. *See id.*; Amendment n. 3, art. 19(1), EUR. PAR. DOC. (COM 2000) 329.

84. Amendment n. 7, new art. 22a, EUR. PAR. DOC. (COM 2000) 329.

85. In the United States, for example, the Dow Jones Industrial Average is a market index composed of thirty stocks of various industries. *See Current Components for Dow Jones Averages*, at <http://www.djindexes.com/jsp/componentLinks.jsp?prodnum=8&cntrynum=1&currnum=1&groupnum=2&mktcaprngnum=1&compfile=uiComponentsRep.jsp?flag=Market®NCNTRY=1.1@USA&MKTSECT=2.2@.Industrial+Average&MKTCAP=1>. The stocks which make up the Dow Jones Industrial Average have adjusted weights ranging from approximately one to seven percent. *See id.* If a UCITS manager wanted to track an index such as the Dow, it would necessarily have to invest more than five percent in any one security.

86. *See* EUR. PAR. DOC. (COM 2000) 329, explanatory memorandum, at 8-9.

87. *See id.*

88. *See id.* at 12.

89. *See* EUR. PAR. DOC. (COM 2000) 331, explanatory memorandum, at 4.

90. *See id.* Amendment n. 3, art. 5-6, EUR. PAR. DOC. (COM 2000) 331, at 16, 21.

91. *See generally* EUR. PAR. DOC. (COM 2000) 331, explanatory memorandum, at 12, 14; *see generally* Amendment n. 3, arts. 5d & 6a, Eur. Par. Doc. (COM 2000) 331, at 19, 23.

Prior restrictions prohibited management companies from engaging in activities other than individual collective portfolio management.⁹² These restrictions have been repealed, permitting management companies to provide portfolio management services to individual and institutional investors (such as pension funds), and also allow management companies to give investment advice.⁹³ Because the structure and operation of investment companies differs among member states, the amendment defines conditions by which certain functions can be delegated to third parties.⁹⁴ Management companies are also required to implement internal control mechanisms to ensure professional and reliable conduct of the business.⁹⁵

Another major aspect of the amendment modifies the information and disclosure documents provided to investors.⁹⁶ Previous disclosure requirements of the UCITS Directive did not adequately provide the average investor with facts that are necessary to make an informed investment decision.⁹⁷ Investors were provided a substantial amount of detailed information that lacked the clarity and simplicity required for average investors.⁹⁸ The amendment therefore requires that a simplified prospectus be offered to potential investors before a contract is formed.⁹⁹ The simplified prospectus must be written in easily understandable language, which could mean the official language of the host state or other natural language of the individual investor.¹⁰⁰ Distribution of the full prospectus, which contains more detailed information including the fund rules or instrument of incorporation, will no longer be required unless the investor so requests; in which case the full prospectus will be available free of charge.¹⁰¹ Aside from the minimum requirements of the UCITS Directive, member states are permitted to specify stricter or additional mandates relating to the regulation of management companies and simplified prospectuses.¹⁰²

92. See EUR. PAR. DOC. (COM 2000) 331, explanatory memorandum, at 4.

93. See *id.*; see also Amendment n. 3, art. 5, EUR. PAR. DOC. (COM 2000) 331, at 16.

94. See Amendment n. 3, art. 5g, EUR. PAR. DOC. (COM 2000) 331, at 20-21.

95. See Amendment n. 3, art. 5f, EUR. PAR. DOC. (COM 2000) 331, at 20.

96. See EUR. PAR. DOC. (COM 2000) 331, explanatory memorandum, at 4.

97. See *id.* at 9.

98. See *id.*

99. *Id.*; Amendment n. 10, art. 33, EUR. PAR. DOC. (COM 2000) 331, at 27; *cf.* Investment Company Act Release No. 23065, 63 Fed. Reg. 13968 (March 13, 1998) (New Disclosure Option for Open-End Management Investment Companies).

100. See Amendment n. 13, art. 47, EUR. PAR. DOC. (COM 2000) 331, at 28; see also EUR. PAR. DOC. (COM 2000) 331, explanatory memorandum, at 17; *cf.* Investment Company Act Release No. 23065, 63 Fed. Reg. 13968 (March 13, 1998) (New Disclosure Option for Open-End Management Investment Companies).

101. See Amendment n.10, art. 33, EUR. PAR. DOC. (COM 2000) 331, at 27; *cf.* Investment Company Act Release No. 23065, 63 Fed. Reg. 13968 (March 13, 1998) (New Disclosure Option for Open-End Management Investment Companies).

102. See EUR. PAR. DOC. (COM 2000) 331, explanatory memorandum, at 19.

IV. REGULATION OF INVESTMENT FUNDS IN THE UNITED STATES

When Congress enacted the Investment Company Act of 1940 (ICA), it recognized that the unique character of investment companies requires substantive protections beyond the requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934.¹⁰³ The general objectives of the ICA are to

prevent insiders from managing the companies to their benefit and to the detriment of public investors; prevent the issuance of securities having inequitable or discriminatory provisions; prevent the management of investment companies by irresponsible persons; prevent the use of unsound or misleading methods of computing earnings and asset value; prevent changes in the character of investment companies without the consent of investors; prevent investment companies from engaging in excessive leveraging; and ensure the disclosure of full and accurate information about the companies and their sponsors.¹⁰⁴

The Investment Company Act requires the structure of funds to be based on the corporate model with investment advisors¹⁰⁵ and a board of directors¹⁰⁶ elected by shareholders. Unless exempted,¹⁰⁷ transactions in interstate commerce of the United States are prohibited by funds that are not registered under the Act.¹⁰⁸

The Investment Company Act provides a nearly insurmountable barrier to registration of foreign collective investment funds. Section 7(d) of the Act prohibits transactions in interstate commerce by any company that has not been "organized under laws of the United States or a state."¹⁰⁹ A foreign collective investment fund may not use any means of interstate commerce in the United States to publicly offer for sale, sell, or otherwise deliver a sale of its shares unless the Securities and Exchange Commission so permits.¹¹⁰ The SEC is authorized to issue an order allowing a foreign investment company to register under the ICA if the Commission finds that it is legally and practically feasible to enforce provisions of the Act against the foreign company, and if issuance of the order is consistent with the public interest and the protection of investors.¹¹¹ Section 7(d) was enacted to give the SEC authority to enforce

103. See SEC REPORT, PROTECTING INVESTORS, *supra* note 3, at xvii (1992).

104. See *id.* at xviii; see also 15 U.S.C. § 80a-1(b)(1)-(8) (2000).

105. 15 U.S.C. § 80a-15 (2000).

106. 15 U.S.C. § 80a-16 (2000).

107. Exemptions from the Investment Company Act are provided in 15 U.S.C. § 80a-6 (2000).

108. 15 U.S.C. § 80a-7 (2000).

109. See *id.*

110. See *id.*

111. See *id.*

investor protections of the ICA against foreign funds operating in the United States.¹¹² The enforcement provision of section 7(d) precludes foreign investment companies from offering shares in the United States by essentially requiring them to restructure as a United States investment company.¹¹³ Accordingly, no foreign investment company has registered in the United States since 1973.¹¹⁴

Irrespective of section 7(d), foreign collective investment funds may publicly market shares in the United States through "mirror funds."¹¹⁵ A mirror fund invests in similar securities to an existing foreign investment company, but is organized and registered under the Investment Company Act.¹¹⁶ The staff of the Securities and Exchange Commission has advised foreign investment companies subject to laws conflicting with the ICA to form mirror funds in the United States.¹¹⁷ This approach, however, tends to be a burdensome and expensive option for foreign companies wishing to market collective investment shares in the United States.¹¹⁸ Additionally, the need to create mirror funds to market foreign collective investment products drastically reduces liquidity and economies of scale which would otherwise be attained if the funds could be freely marketed across borders.¹¹⁹ The staff of the SEC's Division of Investment Management has recognized that the mirror fund option is an inadequate solution to internationalization of the fund industry.¹²⁰

V. SIMILAR PROBLEMS WITH THE UCITS DIRECTIVE

While the primary objectives of the UCITS Directive and the Investment Company Act are largely shared, the specific requirements of the respective laws significantly differ. The staff of the Securities and Exchange Commission has recognized that the UCITS Directive "may be more or less restrictive [than United States regulation of investment companies] on any given issue."¹²¹ While the UCITS Directive previously did not address issues such as affiliated transactions, pricing, and the use of fund assets for distribution, the amendments do address these concerns, somewhat harmonizing the approach of the UCITS Directive with that taken by the United States.¹²²

Perhaps the greatest disparity may be seen in the approach taken to ensure qualified management of investment companies. While the United States

112. See Investment Company Act Release No. 8959, 40 Fed. Reg. 45424 (Sept. 26, 1975).

113. See SEC REPORT, PROTECTING INVESTORS, *supra* note 3, at xxvi (1992).

114. See *id.*

115. See Investment Company Act Release No. 13691, 49 Fed. Reg. 55 (Dec. 23, 1983).

116. See Investment Company Act Release No. 17534, 55 Fed. Reg. 25322, 25325 (June 21, 1990).

117. See Investment Company Act Release No. 8959, *supra* note 112.

118. See SEC REPORT, PROTECTING INVESTORS, *supra* note 3, at 197 (1992).

119. See *id.*

120. See *id.*

121. See Investment Company Act Release No. 17534, 55 Fed. Reg. 25322, 25326 (June 21, 1990).

122. See *id.*

provides for voting by shareholders and directors, the UCITS Directive authorizes the home member state to approve the choice of directors and the adoption of organizational documents.¹²³ Additionally, while the amendments introduce a simplified prospectus like that required by the United States, the disclosure requirements of the UCITS Directive are less extensive than those mandated by the Securities Acts and the Investment Company Act.¹²⁴

With similar goals to regulation of investment companies, the approaches taken by the United States and the European Union to international marketing of collective investment products are also different in some respects and very similar in others. There are obvious discrepancies between the United States' position on prohibiting transactions in interstate commerce by foreign investment companies¹²⁵ and the European Community's position under the UCITS Directive, which permits such transactions among EU countries.¹²⁶ The UCITS Directive, however, does not allow international marketing of collective investment products by companies from nations outside the European Community.¹²⁷ In order to benefit from the UCITS Directive's single license regime, collective investment funds from the United States and from other countries outside the European Union are required to register a mirror fund in one of the EU member states.¹²⁸ The establishment of mirror funds is the general method used by collective investment funds worldwide to meet the regulatory requirements of foreign jurisdictions.¹²⁹

While the amendments to the UCITS Directive reduce existing barriers to a cross-border market in UCITS, obstacles still remain which prevent complete integration of an internal market in the European Community. Even with the amendments, the UCITS Directive will not ensure a level playing field for financial service industries among EU member states. The lack of a common regulatory system for marketing, advertising, and taxation produces inequities that result in disincentives to invest in UCITS of foreign member states.¹³⁰ Additionally, the proposals do little to promote the international sale of UCITS outside the European Community. However, the single license regime of the

123. See *supra* notes 61 and 96; see also Investment Company Act Release No. 17534, 55 Fed. Reg. 25322, 25326 (June 21, 1990).

124. See Investment Company Act Release No. 17534, 55 Fed. Reg. 25322, 25326 (June 21, 1990).

125. See generally 15 U.S.C. § 80a-7(d).

126. See UCITS Directive, *supra* note 6, art. 4, 1985 O.J. (L 375) at 6. This distinction may become less significant as the European Union's continuing expansion and integration paves the way for a federal Europe.

127. See generally *id.*, section II, 1985 O.J. (L. 375) at 6.

128. See Bernard, *supra* note 68, at 480.

129. See generally *id.* at 469, 478.

130. See Investment Company Act Release No. 17534, 55 Fed. Reg. 25322, at 25326 (June 21, 1990).

UCITS Directive may provide a basis for negotiating agreements for mutual recognition between the EU and other nations.¹³¹

If foreign and domestic regulation of collective investment products effectively addresses the same regulatory concerns and serves the same purpose, countries must reach agreements by which the products may be internationally traded.¹³² Such bilateral and multilateral agreements would create a framework for international cooperation and mutual recognition of investment company regulation without sacrificing investor protection.¹³³ Worldwide changes in domestic policy are necessary to create greater receptivity of foreign investment funds.¹³⁴

VI. CONCLUSION

The free cross-border trade of collective investment funds brings with it the benefits of global finance. Cross-border investment is the foundation for optimal efficiency in the international trade of goods and services.¹³⁵ A free-trading international financial market would facilitate worldwide allocation of resources by increasing market efficiency.¹³⁶ The resulting expansion of global finance is indispensable to the continued growth of worldwide trade. With a broader range of assets for enterprises to globally invest in and the capabilities of modern financial product innovations, investors are better able to strategically invest to meet specifically tailored needs.¹³⁷ This lowers the cost of financing on a worldwide basis and facilitates the expansion of international trade.¹³⁸

The current method of marketing foreign collective investment fund shares has become inefficient in the face of increasing globalization. The need to create mirror funds has only served to hinder internationalization of the fund industry. Forming mirror funds is costly, burdensome and greatly reduces economies of scale. The inefficiencies caused by the mirror fund ap-

131. See EC Directive on Mutual Funds May Serve as Basis for Global Agreement, ICI says, 20 Sec. Reg. & L. Rep. (BNA) 1822 (Dec. 2, 1988).

132. See generally SEC REPORT, PROTECTING INVESTORS, *supra* note 3, at 206 (1992).

133. See *id.* at xxvii.

134. See generally *id.* at 188.

135. See Federal Reserve Board Chairman Alan Greenspan, The Globalization of Finance, Keynote Address at the Cato Institute's 15th Annual Monetary Conference (October 14, 1997), at <http://www.cato.org/pubs/journal/cj17n3-1.html>.

136. See *id.* On the other hand, economic or financial turmoil in a single country can cause a ripple effect throughout the rest of the world as a result of global finance. For example, in 1998 Russia's decision to let the ruble's value fall and default on part of its debt is widely viewed as the reason for a 19% drop in the Dow Jones Industrial Average and global market turmoil. See chart accompanying Gregory Zuckerman, *Industrials Fall 2.4%, Face Threat of Bear's Grip - Stock Rout Continues After Fed's Rate Cut, Appears to Broaden*, WALL ST. J., March 22, 2001, at C1. Also, financial turmoil in Asia in 1997 caused the Dow Jones Industrial Average to drop 7.18%. See *id.*

137. See generally Greenspan, *supra* note 135.

138. See *id.*

proach pose a significant impediment to globalization that warrants legislative reform.

The amendments to the UCITS Directive address issues that help align regulation of the EU fund industry with the goals of securities regulation generally. While the United States approaches investment company regulation somewhat differently than the European Union, the goals of regulation remain the same. Yet, the laws of both the EU countries and the United States do not allow mutual recognition. Countries that have similar goals to collective investment fund regulation and that have in place effective regulations and enforcement must reform their policies to facilitate globalization. As a starting point, European Union Internal Market Commissioner Frits Bolkestein believes that “both the United States and the European Union have an obligation to lead the multilateral rules-based-system . . . [in order to] spread the benefits of open markets and economic prosperity to as many countries as possible.”¹³⁹ With legislative reform, the European Union and the United States can begin to do so.

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139. See European Union Internal Market Commissioner Frits Bolkestein, Financial Integration after the Euro, Address at the Harvard Business School, at http://europa.eu.int/comm/internal_market/en/speeches/spch149.htm.

