INVESTMENT MANAGEMENT ASSOCIATION

POOLING:
HOW CAN FUND MANAGERS RESPOND EFFICIENTLY TO DIFFERENT INVESTOR NEEDS?

Investment Management Association

The Investment Management Association (IMA) is the trade body for the UK-based investment management industry. IMA's members provide investment management services to institutions and private investors through individual fund management agreements and pooled products such as authorised investment funds. Between them, IMA's members manage some €2,800 billion worth of assets in the UK of which €1,265 billion is for non-UK clients. They manage €6,467 billion worldwide.

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Christopher Blakey, Citigroup
Martin Cambridge, Fidelity
Jacques Elvinger, Elvinger, Hoss & Prussen
José-Benjamin Longrée, Credit Agricole
Nigel Nelkon, Barclays Global Investors
Julian Presber, State Street Investment Services
Sean Quinn, Citigroup

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EXECUTIVE SUMMARY

In May 2004, the European Commission published the findings of an 'expert group' investigation into the single market for asset management[1]. Amongst other things, the expert group recommended that:

> "It would be beneficial to recognize asset pooling techniques and structures. As a mid-term perspective new legislative measures should therefore be adopted for pooling techniques and structures. This should be flanked by EU-wide cooperation of national regulators to address legitimate concerns about span of control and operational risks. The industry will support this follow-up process to the UCITS Directive by providing necessary information."

This report attempts to fulfil the promise that the industry will provide the 'necessary information' to enable a fuller debate on pooling, and develop the case for future legislative action. It does so by answering the questions: what are the benefits of pooling? (Chapter II) and what issues arise when pooling? (Chapter III). Having answered those questions, the report goes on to make a number of practical recommendations to enable the pooling of investment and pension funds in Europe (Chapter IV).

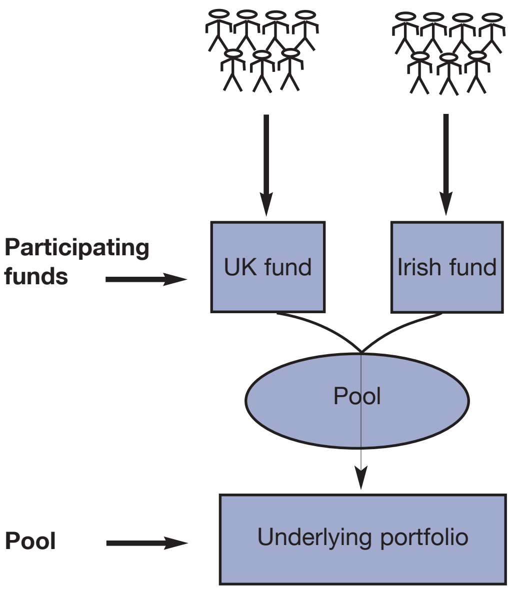
This report *does not* attempt to answer *all* the questions that would need to be addressed by a future regulatory framework for pooling. Rather, the report attempts to define what is meant by pooling and discuss some of the principal fiscal and regulatory barriers that arise, in order to better inform an ongoing debate with the European Commission and other regulators.

CHAPTER I - WHAT IS POOLING?

In its most familiar form, pooling occurs whenever investors aggregate their savings in a collective investment fund or pension fund. However, for the purposes of this report, pooling refers to the aggregation of the assets of investment funds and pension funds themselves.

For example, an investment fund operator who manages the portfolios of investment funds based in, say, the UK and Ireland, could ideally manage those portfolios on a pooled basis. Similarly, the corporate sponsor of pension funds based in, say, Italy and Germany could ideally arrange the management of those portfolios on a pooled basis.

Pooling can take two different forms: 'entity pooling' or 'virtual pooling'.



[1] "Financial services action plan: progress and prospects" (Asset Management Expert Group, May 2004)

Entity pooling aggregates the assets of participating funds through a legal entity, such as a collective investment scheme. The legal entity does not change the economic entitlements of the participating funds, but it may change the legal arrangements by which those entitlements arise. This can sometimes result in certain tax and regulatory issues. Virtual pooling uses information technology to aggregate the assets of participating funds *as if* there were an underlying pool, without actually constituting the pool as a legal entity. Virtual pooling does not therefore change the participating funds' 'quality of ownership' of the underlying portfolio, thus resolving the tax and regulatory issues that might otherwise arise. Virtual pooling is enforceable by contracts between the participating funds and their service providers.

Pooling is permitted within certain Member States of the European Union. For example, Spain, Luxembourg and Germany all have regulations which permit (in varying ways and to varying degrees) pooling of investment funds. However, in the absence of a suitable regulatory framework, it is difficult to pool the assets of European investment or pension funds on a cross-border basis. For example, an investment manager who manages US equities portfolios on behalf of a UK OEIC, Italian SICAV and German investment fonds, is unable to manage those portfolios on a pooled basis. Similarly, a pension fund sponsor who oversees portfolios on behalf of pension funds in the UK, Italy and Germany cannot arrange the investment management of those portfolios on a pooled basis. This impedes the ability of asset managers to realise economies of scale within the single market.

CHAPTER II - WHAT ARE THE BENEFITS OF POOLING?

Pooling enables investment fund operators and pension fund sponsors to realise economies of scale from a number of sources, including:

- Custody (larger pools will be able to negotiate lower custody fees);
- Brokerage (larger transactions will lead to lower unit costs);
- Netting transactions (with more sources coming into the pool the ability to net flows and reduce transaction costs will increase); and
- Administration costs (which are normally transaction based and will therefore be lower in basis point terms if the pool of assets is larger).

The European Federation for Retirement Provision estimated that the benefits of pension pooling (i.e. that aspect of a pan-European pension which can be attributed to the co-management of pooled assets) to be €1,200,000 per annum for the average European multi-national corporation. In a competitive market, these benefits should accrue to manager and investor alike.

Pooling also provides a number of qualitative benefits, including, for example better operational control by facilitating a consistent investment approach. For example, a multi-national corporate sponsor of a large German pension fund and a small Austrian pension fund would be able to appoint a common asset manager to a pool, thereby ensuring a consistent investment approach which reduces the risk to the corporate sponsor of the schemes and enables better long-term funding and financing decisions. This is likely to be particularly beneficial on a cross-group basis.

CHAPTER III - WHAT ARE THE BARRIERS TO POOLING?

Chapter III of the report provides a detailed analysis of the key tax and regulatory barriers to pooling.

The analysis of tax barriers focuses on withholding tax (i.e. tax that is deducted from cross-border payments of interest, dividends, royalties and rent). Interposing a pool between a participating fund and its underlying portfolio of securities should neither increase nor decrease the rate of withholding tax on payments from the underlying portfolio. If the rate of withholding tax increases then investors will be disadvantaged, whereas if the rate of withholding tax decreases then governments are likely to resist the pooling solution (since it will reduce their tax receipts).

In the case of entity pooling, if the pool is considered to be 'opaque' for withholding tax purposes (that is to say, the beneficial owner of the underlying securities), then the rate of withholding tax may be different than if the participating fund had invested directly. If so, then in order to address this problem the pool must be considered 'fiscally transparent' - that is to say, the pool should be 'looked-through' for tax purposes, and the participating funds considered to own the underlying portfolio. In that way, the participating funds will continue to receive distributions net of the same rate of withholding *ex ante*. Chapter III identifies a number of entities which may be regarded as fiscally transparent, and also suggests how tax authorities might develop a common approach to fiscal transparency for withholding tax purposes.

The analysis of regulatory barriers identifies three major issues: investment regulations which treat the pool, rather than the underlying securities, as an investment in its own right, and prohibit or restrict participating funds from making such an investment; custodial regulations, which restrict the ability of participating funds to appoint a custodian to operate the pooling arrangement; and accounting regulations. Investment regulations pose a particular barrier to entity pooling by investment funds, custodial regulations pose a particular barrier to virtual pooling by investment funds, and accounting regulations pose a particular problem for entity pooling of both pension and investment funds. Chapter III identifies the changes that would be required to address those three issues, whilst maintaining appropriate levels of consumer protection.

CHAPTER IV - NEXT STEPS

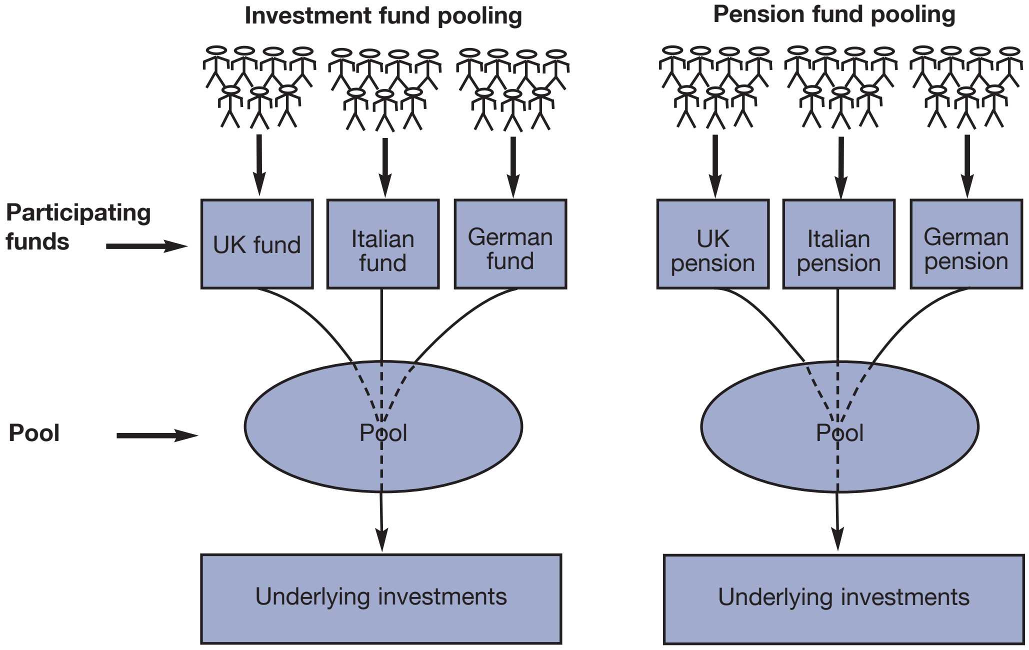
Finally, Chapter IV concludes with concrete recommendations for the next steps required to remove the barriers to pooling identified in Chapter III, in particular identifying how the tax barriers might be resolved through the auspices of the OECD, and how the regulatory barriers might be resolved through the work of the European Commission.

The Investment Management Association (IMA) is eager to support the development of a regulatory framework to enable the pooling of investment funds and pension funds on a cross border basis within the European Union. If readers of this report have any observations or comments to this end, please contact Travis Barker at tbarker@investmentuk.org.

CHAPTER I: WHAT IS POOLING?

For the purposes of this report, 'pooling' refers to arrangements and processes for the collective management of the assets of investment funds or pension funds (hereinafter 'participating funds')[2]:

Pooling by investment and pension funds



Investment fund pooling can be used to aggregate the assets of investment funds from different countries, thereby achieving economies of scale, better operational control, or more flexible product design (i.e. by using those pools as 'building blocks' from which flexible, asset allocator products can be constructed). Similarly, pension fund pooling can be used to aggregate the assets of pension funds from different countries. However, in the case of pension fund pooling it is important to note that despite their pooling assets, the participating pension funds retain separate liability for meeting benefit payments (i.e. there is a pooling of assets, but not of liabilities).

It is important to distinguish between two different ways in which one might achieve pooling: entity pooling and virtual pooling.

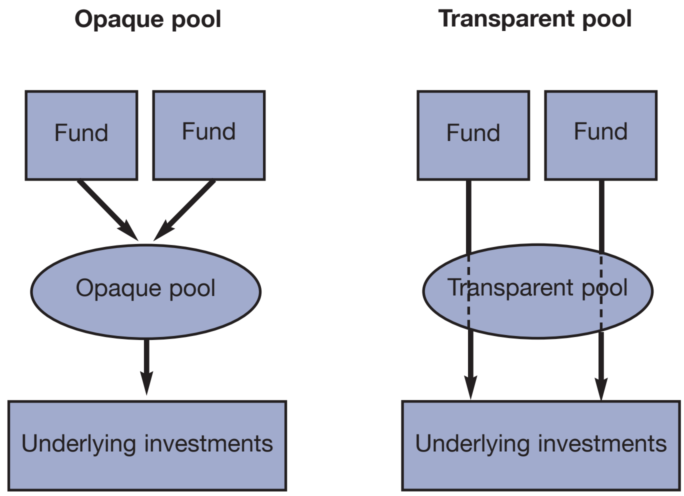
[2] Pooling structures can be distinguished from fund of funds structures. Pooling structures are designed to facilitate investment *by* funds, whereas funds of funds structures are designed to facilitate investment *in* funds. In the sense of the UCITS Directive, pooling is an efficient portfolio management technique.

ENTITY POOLING

Entity pooling utilises legal entities (such as a collective investment scheme) to undertake pooling. In simple terms, one or more participating funds invest in an underlying pool. Units in the pool are valued in proportion to the net asset value of its underlying portfolio of securities. The purpose of this valuation is to make sure that the participating funds enjoy the same economic risks and benefits as if they had invested directly in that underlying portfolio of securities.

Although entity pooling does not, in principle, change the economic entitlements of the participating funds, it may change the legal arrangements by which those entitlements arise. This depends on whether the entity employed as a pool is an 'opaque' or 'transparent' entity:

Opaque and transparent entity pooling



An opaque pool has a separate legal personality of its own. Consequently, the participating funds become the owners of units in the pool which in turn is the legal and beneficial owner of an underlying portfolio of securities. Therefore, although the participating funds retain the same economic risks and benefits as if they had invested directly in that underlying portfolio of securities, their legal entitlement is to units in the pool rather than to the underlying portfolio itself.

A recognised transparent pool has no personality of its own, for taxation purposes. Instead, the participating funds 'contract' between one another for common ownership of an underlying portfolio of securities which is managed through a partnership-type arrangement. Therefore, the participating funds are deemed to remain the beneficial owners of the underlying portfolio of securities for taxation purposes.

Generally, transparent pools are more efficient than opaque pools. This is because transparent pools should not alter the tax and regulatory entitlements of the participating funds in respect of the underlying portfolio of securities. In particular, the transparent pools should be 'looked through' for the purposes of determining the rate of withholding tax deducted from distributions from the portfolio to the participating funds, or for the purposes of assessing compliance with the investment and borrowing restrictions of the participating funds. However, it has proven difficult to identify a pool that is considered transparent by regulatory and fiscal authorities in all the states in which the participating funds and underlying securities might reside. This is described in more detail in Chapter III below. (Contrariwise, although opaque pools may disrupt the entitlements of participating funds to the underlying investments, they are administratively more straightforward to operate).

Entity-based pooling of *investment funds* is common in the USA, where pools and participating funds are commonly described as 'master-feeder funds' respectively. Entity-based pooling of investment funds is uncommon in the EU, since master-feeder funds are not permitted under the UCITS Directive and therefore cannot be distributed on a cross-border basis. However, there are a few EU Member States that permit master-feeder funds for domestic regulatory purposes (e.g. France, Spain and Luxembourg).

Entity-based pooling of *pension funds* has had a chequered history. Although a number of EU Member States have attempted to provide a legislative framework for a transparent pool (such as 'pension fund pooling vehicles' in the UK, FCPs in Luxembourg and, more recently, 'common contractual funds' in Ireland), it has proven difficult for regulatory and fiscal authorities to come to a common view on transparency.

VIRTUAL POOLING

Virtual pooling utilises information technology to enable the assets of participating funds to be co-managed as *if* there were an underlying pool, without actually constituting the pool as a legal entity. The participating funds retain direct legal and beneficial ownership of their underlying assets, with the custodian acting as the keeper of the book of records. Virtual pooling does not compromise the participating funds' 'quality of ownership' of the underlying portfolio, thus resolving a number of tax and regulatory issues that might otherwise arise (see Chapter III).

Virtual pooling is enforceable by contracts between the participating funds and their service providers, in one of two ways:

- A single multiple-signatory contract between the participating funds and the custodian/administrator service provider (multilateral approach);
- Multiple individual contracts between the respective participating funds individually and the custodian/administrator service provider (bilateral approach).

Similarly, the contract with the investment manager can take a multilateral or bilateral form.

The contract must have essential components that provide the legal basis for the pooling arrangement and the securities and cash transactions generated on behalf of, and between, the participating funds as a result of the pooling arrangement. Typically such components include: the right to contribute/withdraw cash or assets to/from the pooling arrangement; the right of other participating funds to contribute/withdraw cash or assets to/from the pooling arrangement; the right to withdraw from the arrangements; the right to exclude other participating funds from joining the pooling arrangement; the finality of ownership changes resulting from contributions/withdrawals to/from the pooling arrangement by any participating fund, etc.

By virtue of the contractual arrangements, the quality of ownership of the participating funds of their securities in the pool remains as if these assets were held in a separate account to the order of those funds. The contractual set-up of a pooling arrangement may (and does in practice) allow any participating fund immediately and at any time to withdraw any or all of the assets (securities, cash and other instruments) it owns in the pooling arrangement, for delivery to a separate, non-commingled custody account.

The custodian/administrator safekeeps the assets and is the keeper of the ownership records. It supplies the technology to enable the ownership records to be maintained at all times, to effect transactions and resulting changes in respective ownership, and to ensure that the transactions generated by the pooling arrangements are executed according to the contract and in a manner which preserves at all times the equity between participants in the pooling structure.

The commingled assets are held in one account serviced by the custodian. This is a straightforward custody "omnibus" account, where the custodian places the assets of more than one client in a single account, either in its own records, or, if the assets are lodged with an external safekeeping agent, in an account serviced by the agent for the custodian, or both. In such arrangements, which are commonplace, the custodian maintains individual client ownership records for these assets separately from the omnibus account record itself.

In the case of virtual pooling, the assets of the participating funds are held in such an omnibus custody account at the custodian. The clients of the custodian are the participating funds jointly. The records of omnibus custody account are maintained by the custodian. The separate ownership and activity records for the assets, individual to each participating fund, are also held by the custodian. In theory, the ownership and activity records could also be held by a third-party administrator. Ownership of the assets, and changes to ownership resulting from activity in the omnibus account, are governed by the pooling contractual arrangements.

Under a virtual pooling arrangement, the investment manager has a contractual mandate from the holders of the omnibus custody account (i.e. the participating funds) allowing him to contract with external parties, such as brokers for the purpose of purchasing and selling securities or other instruments, on their behalf jointly. This falls under the notion of a "joint trading account", whereby the investment manager trades with counterparties in the market on behalf of a "joint trading account X Y Z". The "joint trading account X Y Z" is the legal party in the trade with the counterparty. The contract between the owners of the joint trading account governs their relationship with each other. This is an established and widespread market practice in trading circles and can be easily replicated for the purpose of virtual pooling. In the case of virtual pooling, the participating funds are the owners of the joint trading account, which is the omnibus custody account containing the assets in the pooling arrangement. The investment manager trades on their behalf from this account. The ownership of the assets in the account is at all times governed by the contractual pooling arrangement between the participating funds.

The custodian and administrator, usually but not necessarily the same entity, are key servicing agents in a virtual pooling structure. The custodian operates the information technology that maintains the custody records of the pool in an omnibus account. The administrator operates the information technology that maintains the ownership records of the participating funds with respect to the assets held in the omnibus account with the custodian.

The combined virtual pooling technologies provide the investment manager with a consolidated asset management report of all the assets belonging to the participating funds. The pooling technologies also carry out a double allotment process: one allotment process 'distributes' the proceeds of the global investment/divestment decisions taken by the investment manager, as well as portfolio income and similar events, amongst the participating funds; while the other allotment process adjusts each, or the respective participating funds' ownership of pooled assets as a result of contributions and withdrawals.

Virtual pooling can be used to pool the asset of different subfunds *within* a single umbrella fund ('intra asset pooling') or *between* several funds ('extra asset pooling').

Virtual pooling of *investment funds* is common in Luxembourg, where it can be used to intra-pool subfunds of a single umbrella fund domiciled within Luxembourg. However, in the absence of a common tax and regulatory framework, it has proven difficult to extra-pool investment funds, particularly on a cross-border basis other than by negotiating directly with regulators in Member States.

CHAPTER II: THE BENEFITS OF POOLING

In answering that question and building a case for future regulatory intervention to permit pooling within the EU, this chapter presents its argument according to the framework described by HM Treasury, the Financial Services Authority and the Bank of England in their joint report "After the EU Financial Services Action Plan: A New Strategic Approach", namely:

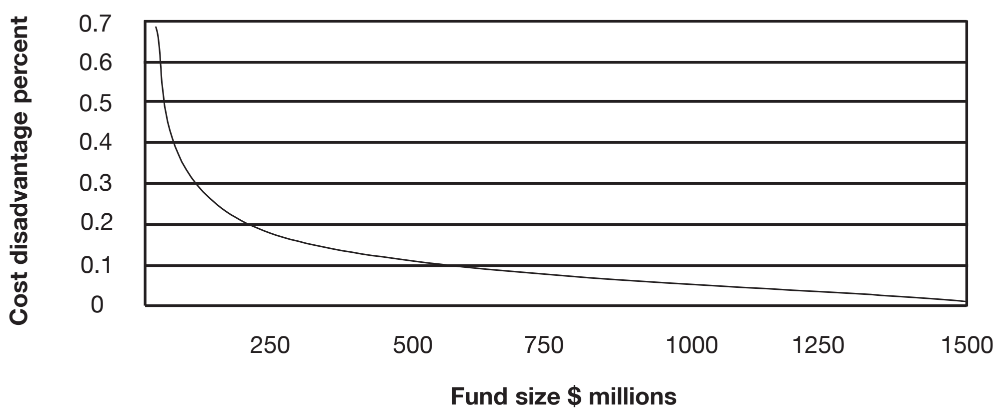
> "The UK authorities believe that, before intervening in financial markets, analysis of the alleged market failure is required. This analysis should be done on an EU-wide basis in order to produce an objective assessment of what, if any, failures exist in a given area of financial services, their nature and extent.
>
> Financial services policy proposals should be based on such analysis. Proposals should then be subject to cost-benefit analysis. The rule of thumb in determining whether EU legislation is appropriate should be that the market failure analysis clearly identifies a need for it, and the cost-benefit analysis of the policy proposal that flow from this analysis demonstrates that the benefits of regulation outweigh the costs".

This report does not purport to provide a *comprehensive* market failure analysis or cost benefit analysis in support of pooling. However, the following chapter does attempt to identify key elements of those analyses, in support of any future regulatory impact assessment that the European Commission or other parties might be expected to produce[3].

MARKET FAILURE ANALYSIS

Investment management is characterised by economies of scale: as assets under management grow, variable and average fixed costs (e.g. execution, custody, administration and distribution) tend to fall. The US Securities and Exchange Commission (SEC) has modeled the relationship between the fund size and costs[4]:

Economies of scale in fund management



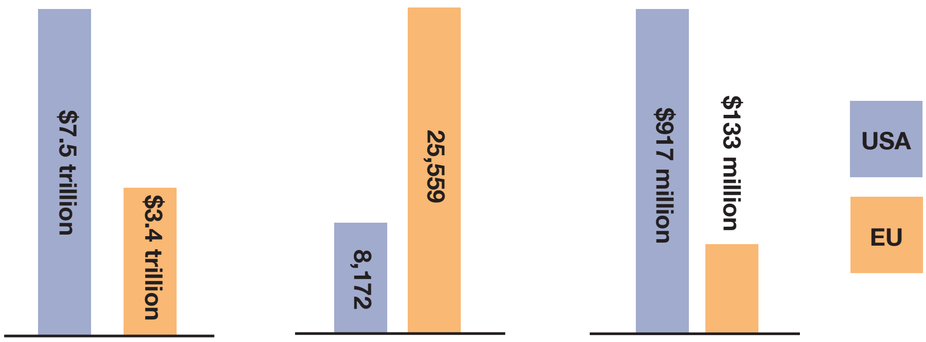
[3] Communication of the European Commission, COM (2002) 278, "Simplifying and improving the regulatory environment"

[4] "Report on mutual fund fees and expenses", S.E.C., December 2000

To maximise economies of scale, investment fund operators and pension fund sponsors generally prefer to distribute or make available a single range of funds on a cross-border basis throughout the EU. European regulations support this by permitting them to 'passport' a single range throughout the EU on the basis of mutually recognised minimum regulatory standards. For example, the UCITS Directive[5] allows authorised investment funds to be sold on a cross-border basis throughout the EU, and the Occupational Pensions Directive[6] will, when implemented, provide a similar opportunity for occupational pension funds.

However, other factors work in the opposite direction. For example, if consumers in country A and country B have a cultural preference for locally domiciled investment funds, then an investment fund operator will have little choice but to establish a fund range in each of those countries if it wishes to compete in those markets. Or if fiscal rules in the two countries provide tax relief for contributions to domestic pension funds but not to foreign pension funds, then a pension fund sponsor will also have to establish two fund ranges. In either case, the effect is to increase the number of fund ranges, which tends to decrease the average fund size and increase average costs. A comparison between the EU and USA is revealing:

Average size of investment funds in the EU and the USA



Size of the market
The US market is twice as big as the European...

Number of funds
..but the European market has three times as many funds as the US...

Average fund size
...therefore, the average US fund is six times larger than that in Europe

Source: FEFSI, ICI, PricewaterhouseCoopers

In principle, one could tackle this issue head on by, for example, educating consumers and distributors about the benefits of foreign investment products, or by challenging instances of tax discrimination[7]. However, there are limits to this approach.

[5] 85/611/EEC

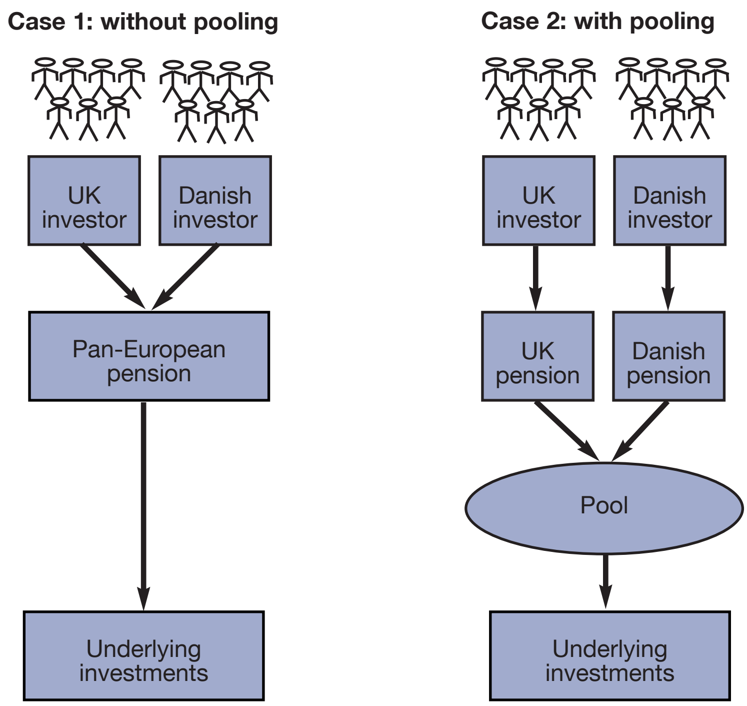
[6] 2003/41/EC

[7] Indeed, the European Commission has shown an increasing appetite to refer discriminatory regimes to the European Court of Justice (ECJ). For example, in July 2003 the Commission began infringement proceedings against tax regimes which discriminate against offshore investment funds in Germany, Austria and (prospectively) France. Similarly, the ECJ has ruled against tax regimes which discriminate against offshore pension funds (by denying tax relief on contributions made to such funds) in Finland and Sweden, and in February 2003 the European Commission began further infringement proceedings against Denmark, Belgium, France, Spain, Italy and Portugal.

For example, it may not be practical or appropriate to try and change a cultural preference for domestic funds, and the European Court of Justice might reject the characterisation of a tax regime as discriminatory if the 'discriminatory' treatment is necessitated by the 'fiscal coherence' of the overall tax regime[8].

Pooling provides an alternative way forward. Consider the figure below:

Using pooling to achieve economies of scale



In case 1 (i.e. in the absence of pooling) a pension fund sponsor attempts to approximate economies of scale by offering UK and Dutch employees pension benefits from a pan-European pension fund. However, if UK and Dutch employees prefer their pension benefits to accrue in a domestic fund, or if the UK and Denmark do not grant tax relief tax relief on contributions made to a foreign pension fund, then this structure may not be possible.

However, in case 2 (i.e. with pooling) these issues no longer arise. Because the contributions continue to be made to domestic pension funds, they enjoy full tax relief. Those contributions are then pooled for investment purposes, consequently enjoying

[8] For example, Member States claim that they have perfectly legitimate reasons for denying tax relief on contributions to offshore pension funds. The effect of the relieving contributions is to defer taxation on contributions sourced from current income until such time as the contributor retires and draws pension benefits. However, when citizens retire to another EU Member State, tax deferral is no longer a coherent fiscal policy: while the contributor state would have borne the cost of exempting contributions from taxation, the other Member State would enjoy the revenue from taxing the resulting benefit stream. The contributor state's taxing rights would no longer be merely deferred but entirely denied, since they would have "drifted" offshore. In cases where the contributions were originally made to a pension fund resident in the contributor state, the loss can be made good by assessing tax at source on cross-border benefit payments by the fund. However, where the contributions were made to an offshore pension fund, the contributor state has no such jurisdiction. Hence the need to discriminate against offshore pension funds by denying tax relief on contributions made to such funds.

economies of scale. Pooling enables the UK and Danish pension funds to enjoy economies of scale without disrupting the *ex ante* fiscal position of the funds. Consequently, pension fund sponsors (and, similarly, investment fund managers) will enjoy most of the economies of scale of a genuine pan-European pension fund/ investment fund without the need to resort to the ECJ, and Member States will secure their due taxing rights without having to disrupt existing fiscal practice.

So, pooling provides investment fund operators and pension fund sponsors with a way to approximate economies of scale, despite the presence of factors which result in the proliferation of fund ranges.

COST BENEFIT ANALYSIS

Cost benefit analysis (CBA) is a decision making tool, which can be used to assess the merits of a particular course of action by subtracting its costs from its benefits. It is increasingly used by regulators to identify 'red tape' - i.e. regulations whose costs exceed their benefits, or whose costs are disproportionately high in relation to their benefits. It is particularly suited to regulations which impose a cost *in order to achieve* a benefit, for example, by requiring factories to invest in new plant in order to reduce pollution, or by requiring firms to offer maternity leave in order to increase social welfare.

Although pooling confers calculable benefits (by liberalising product design and enhancing economies of scale), it does not impose costs in the sense that, say, regulations which impose environmental standards or confer employment rights impose costs, i.e. by requiring some costly adjustment to the situation *ex ante* in order to achieve the benefits of pooling. Pooling is therefore not amenable to CBA in its traditional sense, since the only costs associated with pooling are the costs of the pooling structure itself.

However, pooling is amenable to a modified version of CBA, which compares the benefits of a particular course of action against its *regulatory* costs, i.e. the time and resources that regulators and legislators have to expend to make the associated regulatory changes. In this context, are the benefits of pooling sufficient to merit the European Union and its Member States expending the necessary time and resources to make the associated regulatory changes?

There is strong anecdotal evidence that benefits of pooling are, indeed, worth the necessary regulatory and legislative time and resources, namely that regulators in Luxembourg, Ireland, the UK, and Spain have all made the necessary investment to permit various types of pooling. However, beyond such anecdotal evidence, there are also grounds to believe that the benefits of pooling, in its own rights, are substantial.

Pooling enhances economies of scale. How significant are potential economies of scale in asset management? A recent report[9] estimates annual costs savings of €5 billion per annum if the European asset management industry were able to realise similar economies of scale to those enjoyed by its sister industry in the USA. Pooling would help realise those economies, since the average size of the pool would necessarily be larger than that of the participating funds. Those economies would

[9] "Towards a Single European Market in Asset Management" (Zentrum für Europäische Wirtschaftsforschung and the Investment Management Association, May 2003)

accrue between investment fund promoters and investors.

A recent study by INVESCO[10] also contains pertinent data. INVESCO looked at the fund ranges of the fifty largest European asset managers, and in each case determined the number of funds with duplicate investment strategies. INVESCO found that merging such funds would result in a 63% reduction in the total number of funds being offered, and, consequently, an increase in average fund size of €1.1billion euros. By using the SEC data which plots fund size against expenses, INVESCO estimated potential savings through economies of scale of about €1.62billion euros, or 20bps.

In the case of pension funds, BP's international pensions and benefits team estimated that it could achieve economies of scale of €20million per annum by a combination of "prudent man, margins and pooling"[11]. Similarly, the European Federation for Retirement Provision estimated that the benefits of pooling (i.e. that aspect of a pan-European pension which can be attributed to the co-management of pooled assets) to be €1,200,000 per annum for the average European multi-national corporation[12]. These economies would fall to pension fund beneficiaries in the case of defined contribution schemes and fall between pension fund sponsors and beneficiaries in the case of defined benefit schemes. These savings come from a variety of sources, including:

- Custody (larger pools will be able to negotiate lower custody fees);
- Brokerage (larger transactions will lead to lower unit costs);
- Netting transactions (with more sources coming into the pool the ability to net flows and reduce transaction costs will increase); and
- Administration costs (which are normally transaction based and will therefore be lower in basis point terms if the pool of assets is larger).

Pooling provides other qualitative benefits for investment managers, pension fund sponsors, investors, regulators and fiscal authorities, which are hard to quantify in terms of a cost benefit analysis.

- Pooling will complete a business-model neutral regulatory regime for the single market for asset management. As described above, asset managers typically prefer to establish a single range of 'offshore' funds in order to approximate economies of scale. The UCITS Directive complements this particular business model by providing a regulatory regime which enables such funds to be marketed throughout the single market. However, for those investment managers that prefer to offer an onshore (rather than offshore) fund, pooling would provide an equivalent regulatory regime to complement their business model.

- Pooling facilitates consistency of performance/investment approach to investment fund promoters. It is currently difficult to compare the performance of investment funds following an identical investment approach, because of the differential effect of local taxes, service provider fees etc at the fund level. However, by pooling their assets meaningful comparison of performance can be ensured. It should be emphasised that the participating funds would continue to comply with local

[10] "Building of an integrated European Fund Management: Cross border merger of funds, a quick win?" (INVESCO, January 2005)

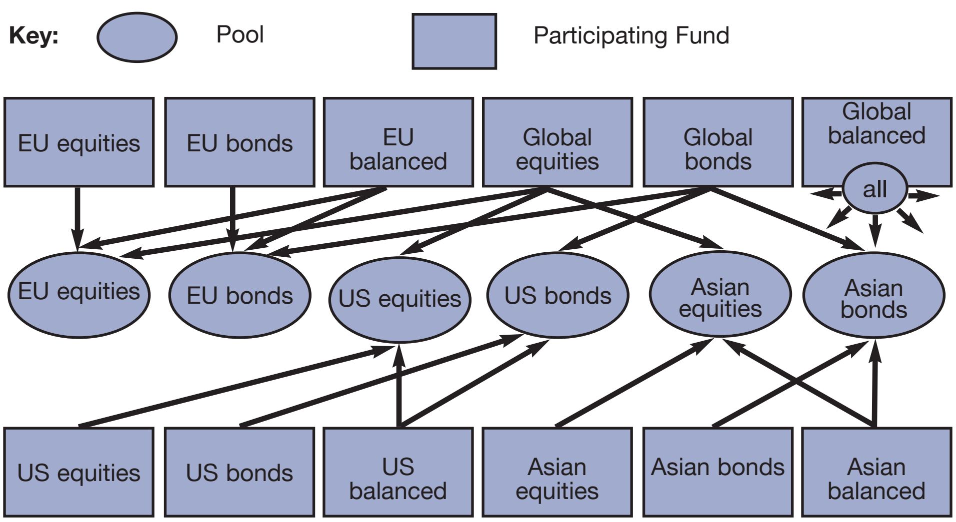
[11] Reported (IPE International Publishers, October 2002)

[12] "A European Institution for Retirement Provision" (European Federation for Retirement Provision, July 2000)

performance reporting requirements, and consequently different performances might be *reported*: however, for management purposes it will be clear that any reported differences arise because of local taxes etc, since the performance of the pool would necessarily be common to all of the participating funds. Similarly pooling provides consistency of Performance/investment approach to pension fund sponsors. For example, a multi-national corporate sponsor of a large German pension fund and a small Austrian pension fund would be able to appoint a common asset manager to a pool, thereby ensuring a consistent investment approach which reduces the risk to the corporate sponsor of the schemes and enables better long-term funding and financing decisions. This is likely to be particularly beneficial on a cross-group basis.

- Pooling facilitates flexible product design for investment managers of pension funds. From the perspective of the asset manager of the pension fund, pooling will allow them to offer an "investment discipline" within a pool - though within a separate segregated wrapper from the institutional client's perspective. This would satisfy the pension fund client's usual preference for segregated management, whilst providing the manager with a more efficient mechanism for providing the investment discipline than by trying to replicate the performance of the fund. Pooling also facilitates flexible product design by promoters of investment funds. For example, the pools can be broken-down into various 'building blocks' which can be assembled in different permutations to facilitate product design. In the figure below, six pools (represented as ellipses) are used to construct twelve participating funds (represented as rectangles). Similarly, a different investment manager could be appointed to each pool, to facilitate the design of 'multi-manager' products.

Pooling and product design



- Pooling enhances risk management of investment managers and pension fund sponsors. For example, where an investment manager separately manages a US equities portfolio on behalf of a UK unit trust, Italian SICAV and a German investment fond with similar investment and borrowing powers, it is somewhat time consuming to ensure that they each remain compliant. However, when those participating funds are pooled, the pool necessarily ensures that their investment policies and performance remain in-synch, and can complement the controls already in place at fund level. Similarly, where a pension fund sponsor pools various participating pension funds, risk management is enhanced.

- Pooling addresses regulatory discrimination against offshore products. By enabling ongoing audit, regulation and fiscal control over the onshore participating fund, pooling assuages fears over the quality of regulation of the offshore pool. Furthermore, pooling reduces the costs of regulatory discrimination against offshore products. For example, if the French PEA regime continues to require the establishment of a French-domiciled investment fund, then pooling that fund's assets will reduce the costliness of the regulatory discrimination.

- Pooling facilitates best-in-class manager selection for multi-national corporate sponsors of pension funds. For example, it would facilitate a multi manager fund of funds to be set up combining (say) a UK OEIC and a German KAG fund etc. This multi manager pool could then be offered to all participants in a company scheme regardless of their domicile. This, of course, is also true of single funds.

- Pooling allows fine-tuning of local investment/pension products. For example, it enables different share classes, currency share classes and pricing regimes of a participating investment fund to be accommodated, while the underlying pool remains consistent between all participating funds. Similarly, it allows each participating pension fund to maintain its own distinct tax, labour or investment policies at the participating fund level while the underlying pool is consistent across all countries.

- Pooling allows small/sub-scale funds to be rationalised. Apart from reducing costs, some of which are passed on to the investor, it would reduce the risk of volatile performance and dilution of returns. For example, a small participating fund with one large investor who pulls out could adversely impact the other owners of the fund. Also, small funds tend to have more concentrated portfolios as they cannot diversify sufficiently due to their size. This concentration is fine if the right stock picks are made but can be damaging if the wrong underlying stocks are owned. The performance of larger funds should be less volatile over time than a small fund with the same investment objectives.

CHAPTER III: WHAT ARE THE BARRIERS TO POOLING?

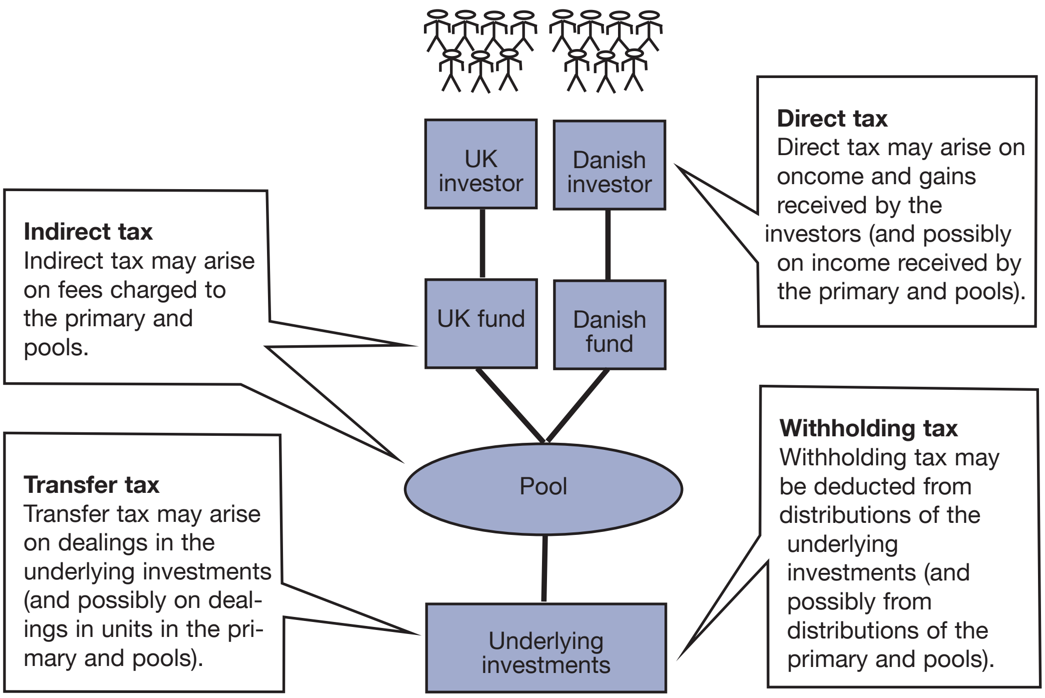
The following chapter distinguishes between two types of barrier - tax barriers and regulatory barriers. Each are described in detail, and recommendations are made as to how they might be resolved.

TAX BARRIERS

Pooling should ideally be neutral from a tax perspective - that is to say, participating funds should receive the same post-tax return through the pooling arrangement as if they had invested directly in the underlying portfolio of securities. If the pooling arrangement impairs the post-tax return of participating funds, then they are unlikely to want to pool their assets, whereas if the arrangement enhances their post-tax return, then fiscal authorities are unlikely to approve the arrangement for fear that it might be used merely to obtain a tax advantage.

More specifically, pooling should ideally be neutral as regards four types of taxation: direct tax, indirect tax, transfer tax, and withholding tax (see diagram below). Our analysis indicates that, of these, withholding tax is likely to be the most problematic. The following narrative therefore focuses on withholding tax, whilst an analysis of the effects of direct, indirect and transfer tax is included in Appendix A.

Summary of taxation issues arising



Withholding Tax

Payments of interest and dividends are typically made net of withholding tax. The rate of withholding tax depends on the double tax agreement (DTA) between the country of residence of the company making the payment and the country of residence of the investor receiving the payment. Typically, the rate of withholding tax prescribed by the DTA will depend upon the nature of the payment (e.g. dividends, interest, royalties, rent etc) and the nature of the investor (typically requiring that the investor be a resident person who is beneficially entitled to the payment).

For example, under the US-Dutch DTA, Dutch pension funds are entitled to receive gross dividend from US companies, whereas under the US-German DTA, German pension funds are entitled to receive US dividends net of 15% withholding tax. Similarly, UK investment funds are entitled to receive Japanese dividends net of 15% withholding tax, whereas Luxembourg investment funds are entitled to receive Japanese dividends net of 30% withholding tax.

Interposing a pool between a participating fund and its underlying portfolio of securities should, ideally, neither increase nor decrease the rate of withholding tax on payments from the underlying portfolio. If the rate of withholding tax increases then investors will be disadvantaged, whereas if the rate of withholding tax decreases then governments are likely to resist the pooling solution (since it will reduce their tax receipts).

In the case of virtual pooling this should not be a problem, precisely because the participating funds retain direct beneficial ownership of the underlying securities (and therefore should continue to receive payments net of the same rate of withholding *ex ante*). In other words, referring to the example above, Dutch and German pension funds would continue to receive US dividends net of 0% and 15% withholding tax, and UK and Luxembourg investment funds would continue to receive Japanese dividends net of 15% and 30% withholding tax[13]. Virtual pooling maintains withholding tax neutrality.

In the case of entity pooling, the situation is a little more complicated.

The assets of participating funds which have *no* treaty entitlements themselves (for example, Luxembourg and Irish investment funds) can be pooled in an entity which also has no treaty entitlements without changing the post-withholding tax returns *ex ante*. Such an entity will typically be a pool which is not a resident person for DTA purposes. There are plenty of pooling entities which fulfil this requirement.

However, the assets of participating funds which *do* have treaty entitlements (for example, Dutch and German pensions funds, and UK investment funds) will generally need to be pooled in an entity which is *transparent* for DTA purposes in order not to

[13] That said, different tax authorities operate different processes for applying reduced rates of withholding tax e.g. some operate relief at source based on the underlying investor entitlement whereas others operate a reclaims procedure, which causes extra administrative/systems costs as well as creating a performance drag due to the cash flow delay in securing repayments of tax. This is aggravated by those tax authorities insisting on the completion of individual forms for each underlying investor rather than accepting a composite form, subject to appropriate safeguards or assurances of investor entitlement. As different withholding tax rates are applicable on the same investments to different investors, the practical system and reporting difficulties become further complicated. Notwithstanding these complications, withholding tax should not be a major barrier to virtual pooling.

change the post-withholding tax returns *ex ante*. A transparent entity is one that is disregarded for DTA purposes - that is to say, the DTA between the company making the payments and the participating fund is applied, irrespective of the fact that the assets of the participating funds are pooled in a transparent entity.

Every country uses different criteria to determine whether or not an entity is transparent. Those criteria typically relate to legal concepts of ownership, which differ from country to country - for example, common law countries use the concept of 'beneficial ownership', which is less familiar in civil law countries. Consequently, the challenge for entity pooling is to identify an entity that is considered transparent by all Member States of the EU and by all target countries of investment (which could potentially include the whole world, but at a minimum should include members of the OECD).

This has proven to be a tall order, despite the best efforts of governments and the asset management industry. For example, some years ago the UK government enacted legislation permitting a new investment vehicle specifically intended to allow transparent entity pooling of pension scheme assets (the 'pension fund pooling vehicle', PFPV) but was frustrated in its efforts when certain other countries failed to treat the PFPV as transparent.

More recently Ireland has enacted legislation permitting transparent entity pooling through a 'common contractual fund' (CCF). A CCF is similar in almost all respects to the Fonds Commun de Placement (FCP), a form of investment vehicle common in Luxembourg, Belgium and France. A CCF is established by a deed executed under seal by its proposed management company, and is governed by the law of contract. Participants (unitholders) in the CCF hold their participation as direct co-owners of the underlying portfolio. Their ownership interests are constituted as "units" which are issued and redeemed and in respect of which a register is maintained by the Manager. Unitholders in a CCF are typically trustees or custodians of the relevant participating fund who hold the units issued on trust for the investors of the participating fund. All these features, and others, are intended to establish the tax transparency of the pooling vehicle:

- Income derived through the CCF is fully distributed, pro rata to each participant's investment in the CCF. This ensures that the income is both accounted for and taxed on an "arising" basis. Similarly, asset are jointly held by participants pro rata to their investment;
- The CCF participants are provided with an annual breakdown of income from the underlying portfolio by type and source;
- There are no redemption charges levied on participants;
- There are no "investor" meetings (which would otherwise provide the CCF with corporate-like features);
- Units in the CCF are redeemable, but are not freely transferable; and
- A CCF should does not have separate legal personality. (Factors which indicate separate legal personality include the capacity to acquire rights and assume obligations, to hold assets and liabilities and to enter into agreements.)

It is hoped that the CCF will be treated as tax transparent for withholding tax purposes. If it is, then other Member States will be able to borrow the legal principles behind the CCF to enact similar legislation. However, if they are not treated as transparent, then how else might one create a fiscally transparent entity for pooling purposes?

The most obvious solution would be to deal with this issue through a European directive. As it happens, there may be some support for this approach from an unexpected quarter, the venture capital industry, which also needs a fiscally transparent investment vehicle to facilitate tax efficient cross-border private equity investments. The European Commission has reflected on the need for tax transparency in the context of venture capital, recently noting[14] the need to "..consider also the merits and the possibility of developing an harmonised European fund legal structure ensuring tax transparency for risk capital operations throughout the Union."

However, taxation broadly remains the competence of Member States of the EU[15]. A directive which intended to establish a tax transparent pooling vehicle would therefore require the *unanimous* support of the European Council of Ministers. Whilst unanimous support is possible, it is extremely difficult to achieve - as recently demonstrated by the Savings Tax Directive. So, if the only solution to transparent entity pooling were a directive, then it might be a long process with no guarantee of success.

However, there are three alternatives to a European directive.

First, one could let national governments continue to enact legal structures until they hit upon one that is treated as fiscally transparent. The problem with this option is that there is no particular reason to suppose that future attempts would succeed where past attempts have failed. Also, this option leaves the market with no timeframe or indication as to when a solution would be available.

Second, one could delegate the task of agreeing principles of fiscal transparency to a specially constituted committee of EU fiscal authorities. There is a recent precedent for this approach in the EU Joint Transfer Pricing Forum (JTPF)[16]. The JTPF comprises representatives of the Commission, Member States and ten experts from the business community. Their objective is to develop a more uniform application of transfer pricing rules within the EU. Significantly, the outcome of the JTPF's work comprises "*pragmatic, non-legislative solutions*". Its work is transmitted on a regular basis to the Council which assesses the need for appropriate action. This pragmatic, non-legislative approach to taxation shares something in common with the non-legislative approach to financial services regulation, in particular the work of the "Level 3 Committees" in the Lamfalussy Process. Perhaps a fiscal committee could be established to agree common principles of fiscal transparency.

Third, one could develop a common approach to fiscal transparency through the auspices of the OECD. In many respects this is the most appropriate and practical way forward, both because the OECD has a specific mandate to facilitate co-operation in the area of international taxation (in particular, through the evolving Commentary to its Model Tax Convention), and because its work is addressed to a wider audience of nations than, say, a European directive would be. By happy coincidence, the OECD's

[14] Communication of the European Commission, COM(2003) 226, "Investing in research: an action plan for Europe"

[15] Indirect tax is harmonised, and there are other specific issues which Member States have unanimously agreed to harmonise, such as the taxation of dividend payments between parent-subsidiary companies.

[16] The JTPF was proposed in the Commission Communication "Towards an Internal Market without tax obstacles - A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities" (COM (2001) 582 which was endorsed by the European General Affairs Council on 11 March 2002.

Working Party No. 1 on Tax Conventions and Related Questions is currently examining the application of the OECD Model Tax Convention to trusts, investment funds and certain other entities. It might be possible, in the context of that work, to develop a common approach to fiscal transparency for pooling purposes.

In principle, one would expect members of the OECD to be willing to develop a common approach to fiscal transparency. After all, fiscal transparency is unobjectionable to the extent that it accelerates the recognition of income and gains for taxation purposes[17]. However, certain other aspects of fiscal transparency are more problematic - namely, its use to create 'hybrid' structures that are transparent under the laws of one country, but opaque under the laws of another. Hybrid structures arbitrage on transparency/opacity to obtain a tax advantage. For example, consider a highly geared company in country A (in which it is regarded as opaque) which is the finance subsidiary of a parent company in country B (in which it is regarded as transparent). The finance subsidiary obtains a deduction for interest expenditure in its home country A (where it is regarded as opaque) while the parent obtains a deduction for the same interest expenditure in country B (where the subsidiary is regarded as fiscally transparent, and its expenditure is therefore regarded as having been incurred by its parent). This phenomenon is known as 'double dipping' (i.e. because it results in the same interest expenditure being deducted twice for taxation purposes). There are other uses that hybrid structures can be put to in order to obtain a tax advantage.

Would it be possible for the OECD to develop a common approach to tax transparency which addresses the legitimate concerns that fiscal authorities have about their possible usage to obtain a tax advantage?

We propose, in the case of a participating fund in country A which utilises a pooling entity in country B to invest in an underlying portfolio of securities in country C, that the fiscal authority in country C ought to regard the pooling entity as fiscally transparent for the purposes of its DTA with country A, if it is so regarded in countries A and B. We describe this as a 'double test' - i.e. the test of transparency from the perspective of the country from which a dividend/interest payment is made, is that the country of the pool and of the participating fund receiving the dividend both regard the pool as transparent.

The double test would address the problem of hybrid structures, income re-characterisation, and competing claims under DTAs. Interestingly, something similar to the double test has been agreed in Article 4 of the recently agreed US-Japan Double Taxation Agreement, indicating that that this might, indeed, constitute the basis for some future common approach to fiscal transparency amongst OECD members.

Assuming that members of the OECD were able to agree a common approach to transparency (whether based on the double test or some other principle) then one final agreement would be required to make fiscally transparent entity pooling a reality - namely, that the operator of the pooling arrangement should be able to make consolidated claims under DTAs acting as agent on behalf of the participating funds. For example, if Dutch and German pension funds participate in a fiscally transparent pool to invest in US equities, then the operator of the pooling arrangement should be

[17] By definition, a transparent pool cannot be used to roll-up income and gains or otherwise defer taxation - participating funds will be taxed on income and gains from underlying securities as they arise, precisely because the pool is transparent

able to reclaim any US withholding tax in excess of their 0% and 15% entitlement, respectively, acting as their agent. Failing this, the Dutch and German pension funds would have to make the reclaim themselves, which would greatly add to the costs of the pooling arrangement.

A number of DTAs already include provisions to this effect. As long as the operator of the pool can provide substantive proof of their identity of the participating funds and their ownership of the underlying securities, no major objections need arise.

REGULATORY BARRIERS

Our analysis has identified two types of regulatory barrier to pooling. The first type of barrier comprises the reluctance of regulators to authorise pooling arrangements because of the risks involved. For example, if the participating funds and the pool are regulated in different countries by different supervisors, then pooling might be objected to on the basis of the risks involved in 'split supervision'. In our opinion, when pooling is properly explained it is possible to allay such fears, and we have attempted such an explanation at Appendix B.

The second type of barrier comprises substantive regulatory obstacles to pooling. There are three such barriers: investment regulations which treat the pool, rather than the underlying securities, as an investment in its own right, and prohibit or restrict participating funds from making such an investment; custodial regulations, which restrict the ability of participating funds to appoint a custodian to operate the pooling arrangement; and accounting regulations. Investment regulations pose a particular barrier to entity pooling by investment funds, custodial regulations pose a particular barrier to virtual pooling by investment funds, and accounting regulations pose a particular problem for entity pooling of both pension and investment funds. Those barriers require a legislative remedy, and are described in detail below.

Investment regulations

Participating funds are typically subject to 'investment and borrowing' regulations which place quantitative and qualitative restrictions on the underlying securities that they may hold. For example, the UCITS Directive requires, *inter alia*, that investment funds should hold a diversified portfolio of securities, and prohibits them from holding more than a certain portion of their assets in financial securities issued by a single issuer. Similarly, the Occupational Pensions Directive requires occupational pension funds to hold a portfolio of financial securities which are predominantly dealt on an exchange and which match the liabilities of the scheme.

The pooling arrangement must be permissible with the parameters of those investment regulations.

In the case of virtual pooling this should not be a problem, precisely because the participating funds retain direct beneficial ownership of the underlying securities, and therefore should be able to meet investment regulations in exactly the same way *ex ante*.

However, in the case of entity pooling a problem arises if units in the pool are treated as an investment in their own right. For example, pooling an entire pension scheme's assets, or a specific asset class of a pension scheme into a pool, could be interpreted as an investment of 100% of the pension scheme's assets, or of its assets in that asset class, into one security - namely, the shares or units of the pool - and thus be in breach of diversification requirements applicable to the pension scheme. Furthermore, since the units in the pool are usually dealt directly with the fund manager, the investment would also be in breach of the requirement that the pension scheme predominantly invest in securities dealt on an exchange.

In order to address this problem one should be able to 'look through' the pool to the underlying portfolio of securities for the purposes of the relevant investment regulations. This would require the investment management and compliance oversight functions to systematically look through the pool, down to the underlying portfolio, for the purpose of calculating diversification ratios.

The Occupational Pensions Directive appears to permit look through in the case of entity pooling by pension funds. Following a meeting on 22 October 2004 of the European Commission and Member States to clarify certain provisions of the Occupational Pensions Directive, it was stated that:

> "Indirect investments via collective investment vehicles where underlying assets are traded in regulated markets, should be treated as being equivalent to direct investment on regulated markets, based on a 'look through' principle."

However, there is no equivalent look through provision in respect of entity pooling by investment funds in the UCITS Directive. Indeed, the Directive regards entity based pooling arrangements as an investment in a collective investment fund which itself is subject to strict concentration limits (i.e. the fund of funds rules). This aspect of the UCITS Directive would therefore require amendment in order to permit entity based pooling by investment funds. Since the principle of look through has been agreed in the case of pension funds, it seems reasonable to suppose that it might similarly be agreed in the case of entity pooling by investment funds.

Custodial regulations

Participating funds are typically subject to regulations which require them to appoint an approved custodian for the purpose of safekeeping their underlying portfolio of securities. The pooling arrangement must be possible within the parameters of those custodial regulations.

In the case of pension funds, Article 19.2 of the Occupational Pensions Directive specifically provides pension funds considerable discretion in the choice of custodian:

Member States shall not restrict institutions from appointing, for the custody of their assets, custodians established in another Member State and duly authorised in accordance with Directive 93/22/EEC or Directive 2000/12/EC, or accepted as a depositary for the purposes of Directive 85/611/ EEC.

Custodial regulations should not, therefore, act as a barrier to pension fund pooling:

However, in the case of investment funds, Member States may make regulations which have the effect of limiting the choice of custodian in one of three ways:

A. Some countries require that the custodian be domiciled in the same country as the investment fund.
B. Some countries require that the underlying portfolio of securities be held directly by the appointed custodian. If this is impractical or does not correspond to the conventions of the home market of an underlying security, it may be held with an agent domiciled in the local market of the asset (the 'subcustodian'), specialized in safekeeping securities of that local market, and participating in safekeeping and ownership transfer arrangements and conventions of the local market.
C. Some countries require that subcustodians (as described in B above) be appointed via a direct contractual relationship between the appointed custodian and the local agent. In these cases, intermediary custodial agents ("global subcustodian" or "regional subcustodian") would contravene this requirement and are therefore not permitted.

In the case of entity pooling by investment funds, these custodial regulations should not be a problem. The participating fund will retain its *ex ante* custodial arrangement, and the pool will enter into its own custodial arrangement. There is no reason to suppose those custodial arrangements will be compromised by the pooling arrangement, any more than is the case with a funds of funds.

However, in the case of virtual pooling of investment funds where any of the above restrictions apply and the participating funds are regulated in different jurisdictions, the ability to appoint a common custodian, and thus the ability to pool assets using virtual techniques, is inhibited, and custodial arrangements must be structured so as to comply with the requirements of each of the concerned jurisdictions. Classically, this problem can be circumvented through the appointment of a common "global subcustodian" by the respective appointed custodians. The "global subcustodian" would have all the pooled assets on its books, and would in turn itself appoint local market agents (subcustodians) in the respective local markets. This arrangement complies with restrictions A and B. Restriction C, however, remains unsolved. To the extent that only one jurisdiction in the virtual pooling structure (for example, Luxembourg) imposes this restriction, a solution can be found by appointing the appointed custodian of the entity of that jurisdiction as "global subcustodian". To the extent that more than one jurisdiction in the pooling structure imposes restriction C, virtual pooling of investment funds may not be possible due to the inability to lodge the underlying portfolio of securities with a common custodian.

The European Commission recently published a Communication[18] which has some bearing on this issue. The Communication notes that:

> "The [UCITS] Directive… specifies that the depositary must have its registered office, either in the same Member State as the authorised fund manager (management company or investment company), i.e. the Member State where the UCITS is authorised, or in another Member State, provided it has a branch in the UCITS ' Member State - it is then subject to the local UCITS competent authorities' approval and "public control". This is restrictive in the modern Internal Market."

The Communication therefore proposed that investment funds should be free to

[18] Communication of the European Commission, COM 2004(207), "Regulation of UCITS Depositaries in the Member States"

appoint approved depositaries from other Member States, in much the same way as pension funds are now permitted to appoint approved custodians from other Member States. The Expert Group on Asset Management also recommended liberalising the single market for depositary services, by providing UCITS with the freedom to appoint cross-border depositaries. This would ultimately provide a solution to the virtual pooling of investment funds: insofar as a Member State prohibits an investment fund's depositary from appointing a global subcustodian, depositaries from that Member State are unlikely to be chosen to provide depositary services to investment funds that utilises virtual pooling.

In fact, the recommendation of the Communication and the Expert Group goes some way beyond what would be required for virtual pooling of investment funds, since all that is required is the freedom to appoint a custodian - a sub-set of the services provided by a depositary. Indeed, it makes sense to distinguish the various services provided by depositaries, because it is likely to prove much less politically controversial to liberalise custody, than, say, oversight. After all, the Occupational Pensions Directive provides a precedent for liberalising custody.

Alternatively, it might be possible to address this issue by prevailing upon those Member States which currently restrict the choice of approved custodian to amend their domestic regulations.

Accounting and performance

Participating funds must account for their underlying investments in accordance with the Generally Accepted Accounting Principles (GAAP) of the country in which they are domiciled. For example, UK domiciled investment funds must account for their investments under UK GAAP and French domiciled investment funds must account under French GAAP. (Similarly they must report fund performance according to local regulations.) GAAP differs from country to country, and consequently participating funds' financial statements vary. Although over time GAAP is likely to converge (most probably on International Accounting Standards), until that time, participating funds domiciled in different Member States will continue to account for their underlying investments in slightly different ways.

Interposing a pool between the participating funds and their underlying portfolio of securities should not disrupt the way in which the participating funds account for their investments (or report their performance).

In the case of virtual pooling this should not be a problem, precisely because the participating funds retain direct beneficial ownership of the underlying securities (and therefore should be able to continue to account for their underlying investments in exactly the same way *ex ante*). Of course, the pooling provider will have to invest in complex and sophisticated technologies that take account of variations in accounting standards between the participating funds, and this is likely to be expensive. It may also have tax implications, since the tax status of a participating fund is sometimes contingent on it adopting certain approved accounting conventions (e.g. in Germany). Nevertheless, the market is likely to find a solution to these problems.

The case of entity pooling is a little more complex. On the one hand, entity pooling should not give rise to any particular accounting issues, because the participating funds should have no difficulty in accounting for their investment in units in the pool.

But on the other hand, if the participating funds merely report their interest in the pool, this would deprive beneficiaries of the participating funds of important information - that is to say, beneficiaries may legitimately expect the financial statements of the participating funds to report the underlying portfolio of the pool, rather than merely units in the pool.

In order to address this problem, participating funds should be required to account (and report performance) as though they had a direct participation in the underlying portfolio of the pool, and pools should only be authorised if they can provide such relevant information to the participating funds. This could be dealt with by regulators in their appropriate 'level 3' committees, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR), respectively.

CHAPTER IV: NEXT STEPS

From the foregoing analysis of the barriers to pooling, it can be seen that the next steps to achieve entity based pooling are quite different from those required to achieve virtual pooling, and the next steps to achieve investment fund pooling are different from those required to achieve pension fund pooling. The following diagram summarises the differences:

	INVESTMENT FUNDS	PENSION FUNDS
ENTITY POOLING	**Withholding tax** The pool must be considered fiscally transparent for withholding tax purposes. **Investment regulations** The UCITS Directive must be amended to permit entity pooling. **Accounting and performance** CESR must advise on accounting and performance.	**Withholding tax** The pool must be considered fiscally transparent for withholding tax purposes. **Accounting and performance** CEIOPS must advise on accounting and performance.
VIRTUAL POOLING	**Custodial regulations** The UCITS Directive must be amended to give UCITS the freedom to appoint custodians on a cross-border basis.	

This summary indicates that action will be required from three parties to enable pooling.

First, the European Commission will need to act to amend the investment and borrowing powers and custodial provisions of the UCITS Directive. Fortunately, the Commission is already engaged in the process of identifying aspects of the UCITS Directive which require amendment as part of the 'UCITS review' mandated by Article 2 of the UCITS 'Product' Directive[19], which, amongst other things, requires the Commission to:

[19] 2001/108/EC

> "…review the scope of the Directive in terms of how it applies to different types of products (e.g. institutional funds, real-estate funds, master-feeder funds [i.e. pooling arrangements] and hedge funds); the study should in particular focus on the size of the market for such funds, the regulation, where applicable, of these funds in the Member States and an evaluation of the need for further harmonisation of these funds".

We urge the Commission bring forward measures to permit virtual and entity pooling, as part of this work.

Second, investment and pension fund regulators need to be familiarised with pooling techniques. We therefore recommend that CESR and CEIOPS be requested by the European Commission to host a discussion on pooling, including practitioners, amongst Member State regulators. Regulators of those Member States which already permit pooling can be expected to take an active role in explaining to other regulators how pooling works and how best it can be monitored and enforced. Indeed, such sharing of best practice and regulatory convergence was the rationale for establishing CESR and CEIOPS as 'level 3' committees. Pooling could prove an important opportunity to test that rationale, and to tackle any other regulatory issues which may arise.

Third, a common approach to fiscal transparency needs to be developed. As described in Chapter III above, we believe that this is best developed through the auspices of the OECD's Working Party No. 1 on Tax Conventions and Related Questions which is currently examining the application of the OECD Model Tax Convention to trusts, investment funds and certain other entities. The European Commission is an observer member of that working party and so may be able to take an active role in developing a way forward. Also, since some countries have already developed a 'mutual recognition'-type approach to fiscal transparency, they may be able to share their experiences with others.

CONCLUSION

On 5 April 2005, Commissioner Charlie McCreevy gave a speech in which he observed:

> "I am conscious that current UCITS legislation may entail missed opportunities for the industry: it doesn't provide for effective exercise of a wide range of single market freedoms or respond to the reality of a fast changing business. This translates into higher costs and a more limited range of opportunities for investors. In addition the current UCITS model does not seem to be able to keep pace with product innovation. The mandate to review the UCITS framework is motivated, among other things, by these considerations. The Commission's paper on UCITS is currently in preparation and will be published in the summer. It will conclude that no case currently exists for wholesale changes to the existing legislation. Instead the review will outline a number of steps that are envisaged to consolidate the existing UCITS framework. It will identify areas for short-term action and structural issues which warrant further monitoring. The industry will be asked to respond by November 2005 and only when those responses have been received will consideration be given to what amendments to the existing framework may be appropriate."

We concur with this assessment. The single market for asset management is best advanced through incremental change to existing legislation, rather than wholesale reform. This report has identified the incremental reforms required to enable pooling by investment and pension funds, which, in turn will promote economies of scale in asset management, more sophisticated product development, better risk management, and a mechanism to adapt institutional asset management to developments in the fiscal treatment of pension funds.

This paper has *not* attempted to answer *all* the questions that would need to be addressed by a future regulatory framework for pooling, for example: how should a pooling arrangement be disclosed in the prospectuses of participating funds?; what supervisory approvals should be obtained in order to enter into or exit from a pooling arrangement?; what should be the precise legal and regulatory relationship between the pool and its participating funds?; how would the UCITS directive need to be specifically amended in order to permit pooling? should both the participating fund and its pool be certified as UCITS?; should there be a maximum and/or minimum threshold of assets to be invested by a participating fund in a pool? Rather, this paper attempts to define what is meant by pooling and discuss some of the principal fiscal and regulatory barriers that arise, in order to better inform an ongoing debate with the European Commission and other regulators.

We therefore hope that the Commission will look favourably on creating a regime for pooling as part of its ongoing work, and we stand prepared to provide whatever further technical or commercial assistance is required to help achieve that objective.

APPENDIX A - TAX ISSUES

This Appendix provides an analysis of the impact of pooling on direct tax, transfer tax and indirect tax.

DIRECT TAX

Direct tax may arise on an investor in a participating fund in a number of ways. Income tax may arise on payments of dividends and interest by an investment fund to an investor (or, in similar vein, on benefits paid from a pension fund to a scheme beneficiary[20]); and capital gains tax may arise on disposals of shares/units in an investment fund. Inheritance tax may also arise on the value of investment funds or accrued pension benefits included within an investor's estate.

Direct tax regimes often discriminate against offshore funds, thus predisposing investors to locally domiciled funds. Pooling provides a solution to the problem of tax discrimination. By keeping local participating funds in place whilst managing their assets through a pool: investors continue to enjoy the same direct tax treatment *ex ante*; Member States retain control over tax administration; and asset managers approximate economies of scale.

However, although pooling can resolve tax discrimination, it may give rise to other direct tax issues.

Income categorisation

In most Member States, certain categories of income are taxed at different rates or in different ways in order to minimise double taxation. For example, because dividends are paid out of the taxed profit of a company, it would be inequitable to tax them a second time when received by investors. Therefore, dividends are usually partially relieved from tax when received by investors. Contrariwise, because interest payments are made from the gross profit of a company, they are usually fully taxed when received by investors. Other categories of income that are subject to a differential direct tax rate when received by investors in certain Member States include capital gains, rental income and income from derivatives. It is therefore important that investors know what category of income they are receiving from their investments. This is easy enough to monitor when they invest directly in a portfolio of securities. However, when they invest indirectly via an investment fund, income categorisation issues may arise.

There are numerous ways of resolving this issue. For example, in some Member States this issue is resolved by requiring investment funds to 'stream' their distributions to investors in proportion to the underlying income of the fund. For example, if an investment fund receives three-quarters of its income as dividends and one-quarter as interest, then an investor receiving a distribution of €100 from the fund will be taxed as though he had received €75 dividend income and €25 interest income. In other Member States this issue is addressed by treating the distribution by the investment fund to be of a type made by the majority of its underlying portfolio. For example, if an investment fund is predominantly invested in equities, then its distributions are treated as dividend payments, whereas if it is predominantly invested in debt securities, then

[20] Ordinarily, contributions paid to pension funds by corporate sponsors on behalf of employees are exempt from tax, i.e. the corporate sponsor is entitled to a tax deduction in respect of the contribution, and the employee is not assessed on the contribution as a benefit in kind. Some Member States do tax contributions e.g. Luxembourg. Other Member States tax contributions which are made to offshore pension funds, as described above.

its distributions are treated as interest payments.

Interposing a pool between a participating fund and its underlying portfolio of securities must not interfere with these various solutions to the issue of income categorisation.

In the case of virtual pooling this should not be a problem, precisely because the participating fund retains direct beneficial ownership of the underlying securities (and can therefore continue to either stream its income or assess its underlying portfolio).

In the case of entity pooling a problem may arise if distributions from the pool to the participating fund are characterised differently from a direct investment by the participating fund in the underlying securities. In order to address this problem the pool must be considered transparent for taxation purposes. In that way, the participating fund will be able to continue to 'stream' its distributions and/or assess whether it is predominantly invested in equities or debt securities in the same way as if it had invested directly in those securities.

Direct tax on the primary/pool

In principle, participating funds should not be subject to direct tax, otherwise income from the underlying portfolio of securities will be taxed twice: first, in the hands of the fund; and second, in the hands of the investor. To avoid such double taxation, participating funds are therefore generally exempted from tax. The mechanism for the exemption varies from Member State to Member State. For example, French SICAVs are fully exempt from tax on income and gains; UK OEICs are subject to corporation tax at 20% but may offset withholding tax deducted from dividend receipts and consequently rarely pay direct tax; Luxembourg ASSEPs are fully taxable other than on income from investments - which is the only type of income they receive; and Dutch pension funds are exempt from direct tax.

However, in certain instances direct tax may arise on the participating fund. For example: Italian pension and investment funds are subject to an annual tax (which is credited when calculating investor taxation); and UK investment funds are subject to tax when they receive foreign dividend income which is paid gross of withholding tax (such as dividends from Hong Kong, or from other offshore investment funds).

Interposing a pool between a participating fund and its underlying portfolio of securities should not increase the direct tax burden of the participating fund (if any), otherwise the pooling structure will inefficiently reduce the post tax returns to investors.

In the case of virtual pooling this should not be a problem: the participating fund will be subject to exactly the same direct tax burden as if it had invested directly in the underlying securities.

In the case of entity pooling a problem may arise if the pool is itself subject to any form of direct taxation. Fortunately, market forces may provide a solution to this problem: insofar as a Member State's tax regime adds to the direct tax burden, that Member State is less likely to be chosen as a country of domicile for the pooling entity.

TRANSFER TAX

Certain Member States charge transfer tax on the purchase and sale of financial securities. For example, in the United Kingdom stamp duty reserve tax is assessed on the purchase and sale of UK registered equities.

Transfer tax on the re-allotment of a portfolio of securities

Interposing a pool between a participating fund and its underlying portfolio should not increase the transfer tax paid on the purchase and sale of securities in that portfolio.

In the case of entity pooling this should not be a problem: the pool will continue to purchase and sell the underlying portfolio in the same way as if the participating fund had invested directly, and no incremental transfer tax should arise merely by virtue of the pooling arrangement.

In the case of virtual pooling a problem may arise when assets are re-alloted between participating funds following a cash contribution. As described in Chapter I, virtual pooling solutions employ an IT package to provide the investment manager with a consolidated asset management report of all the assets belonging to the participating funds. The IT package also carries out a double allotment process: one allotment process 'distributes' the proceeds of the global investment/divestment decisions taken by the investment manager amongst the participating funds; the other allotment process adjusts the participating fund portfolios further to subscriptions, redemptions, conversions or distributions. The second allotment process can give rise to transactions between participating funds, following a subscription of cash. Consider the following example.

		Fund A	Fund B
T_0	Funds A and B each have net assets of €1000 which are virtually pooled. A and B are wholly invested in BP shares worth €1 each.	1000 €1 BP shares (1000/2000 x 2000)	1000 €1 BP shares (1000/2000 x 2000)
T_1	Fund A receives a cash contribution of €50. In aggregate, funds A and B now contain 2000 BP shares worth €1 each and €50 cash. The entitlements of funds A and B are re-allotted.	1024 €1 BP shares (1050/2050 x 2000) €26 cash (1050/2050 x 50)	976 €1 BP shares (1000/2050 x 2000) €24 cash (1000/2050 x 50)
T_2	The €50 cash contribution is used to purchase 50 BP shares worth €1 each.	1050 €1 BP shares (1050/2050 x 2050)	1000 €1 BP shares (1000/2050 x 2050)

As a consequence of the re-allotment process, fund B first "sells" then "reacquires" 24 €1 BP shares to/from fund A in exchange for €24 cash. Conceptually, this is no different to what happens within a participating fund when a new investor purchases shares/units for cash i.e. existing investors' share of the underlying portfolio are temporarily 'diluted' with cash until such time as the cash is invested. Although the re-allotment process does not give rise to any *a priori* regulatory issues, it does result in a large number of apparent transactions between the participating funds (i.e. every time there is a cash subscription). Although transaction tax should in principle only be assessed on the €50 subscription that is used to purchase BP shares, there is a risk that the €24 re-allotment transactions between fund A and B might also be assessed. If so, the virtual pooling structure will inefficiently reduce the post tax returns to investors.

Market forces may resolve this issue: after all, to the extent that a Member State assesses transfer tax on the re-allocation of financial securities between participating funds, it will inequitably add to the cost of capital of locally registered companies. In order not to disadvantage local enterprise, it seems likely that that the Member State would therefore endeavour to provide a more equitable basis for assessing the transfer tax. Failing that, investment managers are likely to turn to synthetic instruments to maintain exposure to the underlying investment and avoid such costs. However, this isn't always possible for example, because of regulatory investment restrictions from investing in such instruments which can increase the risk profile of the fund. It can also lead to sub-optimal performance/benchmark tracking errors.

Transfer taxes on the participating fund and the pool

Notwithstanding transfer taxes on the underlying portfolio of securities, transfer taxes may also arise on the purchase and sale of units in a fund. Interposing a pool between a participating fund and its underlying portfolio of securities must not increase the transfer tax paid on purchases and sales of units in the pooled funds.

In the case of virtual pooling this should not be a problem: the pool is not a legally constituted entity and so transfer tax on units in participating funds will not change merely because those participating funds pool their assets.

In the case of entity pooling a problem may arise if units in the pool are assessable to transfer tax. Fortunately, market forces may provide a solution to this problem: insofar as a Member State's tax regime adds to the transfer tax burden of a pool, that Member State is less likely to be chosen as a country of domicile for a pool.

INDIRECT TAX

Interposing a pool between a participating fund and its underlying portfolio of securities should neither increase nor decrease the VAT treatment of expenses charged to the participating fund. If the amount of VAT increases, then investors will be disadvantaged, whereas if the amount of VAT decreases then governments are likely to resist the pooling solution (since it will reduce their tax receipts).

In the case of virtual pooling this should not be a problem, precisely because the participating funds continue to bear the same expenses (and consequential VAT treatment) *ex ante*.

In the case of entity pooling a problem may arise if the pool is treated differently than the participating funds. This in turn will depend on whether those participating funds are investment funds (e.g. UCITS) or pension funds.

In principle, the Sixth VAT Directive exempts 'special investment funds' from VAT. So in the case of entity pooling, the pool would also need to be treated as a special investment fund in order to make sure there was no difference in the overall VAT treatment. However, the definition of special investment fund is left to Member States, and each country has different criteria. Most make their definition by reference to the UCITS Directive but Austria, for example, requires that the special investment fund be managed by someone with a banking licence. In some countries (e.g. Luxembourg) it is the designation in the home jurisdiction of the fund that determines whether VAT is to be levied or not by the investment manager whereas in others (e.g. the UK) the domestic designation of the fund is not relevant.

In the case of cross-border provision of investment management services to pension funds, the VAT treatment generally depends on whether they are regarded as being 'in business' or not. In those countries that regard pension funds as being in business, the supplier of the investment management service, would not levy VAT when charging the pension fund (albeit, depending upon the treatment of the pension fund in its home jurisdiction, the pension fund could be subject to a payment of VAT under the 'reverse charge' mechanism). In those countries that do not regard pension funds as being in business, VAT would generally be levied on investment management services by the supplier. It is hard to see how these differences could be reconciled in the case of entity based pooling.

A more consistent VAT treatment would assist entity pooling at an EU level through simplifying and reducing the administrative burden of having to apply different charging methods to investors according to their jurisdiction. Because VAT (unlike direct taxation) is harmonised, this is a feasible option. In particular, uncertainty in the marketplace surrounding the definition of terms in VAT legislation such as what constitutes "management" for example, particularly in the context of outsourced activities has not helped pooling through complicating the commercial arrangements/basis upon which the pooling is undertaken. It is understood that the European Commission proposes to clarify certain key definitions in the Sixth VAT Directive, so this problem may diminish going forward.

Alternatively, either all expenses should continue to be charged to the participating fund and none to the pool (although this may not be commercially feasible), or the pool must be considered transparent for taxation purposes and therefore its expenses allocated to the participating fund for VAT purposes.

APPENDIX B - STAKEHOLDER EDUCATION

Our analysis has identified the need to educate stakeholders about certain aspects of pooling which are commonly misunderstood and, on that basis, are used to object to pooling. This appendix identifies the most common such objections.

Split supervision

Traditionally, the most common objection to pooling was that it would result in 'split supervision' if the participating funds and the pool were regulated by different supervisors in different countries. However, if the participating fund and the pool each have their own separate management companies, then the pooling arrangement will no more give rise to split supervision than is already possible following recent amendments to the UCITS Directive which permit funds of funds - that is to say, a UCITS (and its management company) which is regulated in one country is now permitted to invest all of its assets in UCITS (and their management companies) which are regulated in other countries. If, on the other hand, both the participating fund and the pool share the *same* management company then split supervision will, indeed, arise. However, split supervision in this sense will only be possible if the management company passport is broadened, which is part of a different debate to pooling *per se*.

Joint trading

In certain countries, regulators demand that an investment manager who places a global order in the market on behalf of several clients (i.e. in this context, several pooled participating funds) allocates the securities bought through this global order in advance (*ex-ante*). The rationale for this rule is that it prevents the investment manager from favouring one of its clients by allocating the proceeds of the global purchase at point in time where the trend of the market is known (*ex-post*).

In general, pooling arrangements need not fall foul of such requirements providing the criteria on which the partition of the purchased assets is made, are objective. As long as the criteria governing how the global order should be split are clear, specified in advance and may not be changed at the sole discretion of the investment manager, there should be no reason for the regulator to prohibit joint trading on behalf of pooled funds.

Allocation of transaction costs

Two types of transaction costs may arise: investment transaction cost; and re-allotment transaction costs.

Investment transaction costs arise as a result of investment decisions made on behalf of the participating funds by the investment manager. The cost of investment transactions are borne by each participating fund in proportion to its participation in the pool. For instance, participating funds A and B are pooled. A has a portfolio worth €400million whereas B has a portfolio worth €600million. If the investment manager to A and B places a global order on the market for 1000 BP shares, A will receive 400 shares and B 600. The investment transaction cost will be borne in the ratio 40:60 by A and B respectively. This is clearly an equitable allocation of transaction costs.

Re-allotment transactions arise as a consequence of subscriptions and redemptions to/from virtually pooled participating funds (see the narrative dealing with transfer taxes in Appendix A). As a result of a re-allocation, one participating fund automatically acquires securities from other pooled participating funds at no transaction cost. The subscription cash that triggers the re-allotment process is then invested in the market and new securities are bought by the investment manager on behalf of the participating funds, and the consequent transaction cost is shared between the participating funds on a pro rata basis as described above. Hence a pooled fund that has just transferred securities to other pooled funds, is obliged right after that to re-invest this cash and pay transaction cost on these new investments. If this is not closely monitored, it may lead to abnormal situations if not situations that are detrimental to one or several of the pooled entities.

Most experts agree on the fact that these situations are inherent to pooling techniques of all kinds (the functioning of investment funds, for instance, raises the same issue) and that they are acceptable as long as: it is not always the same pooled entity that is subscribed with cash and obliged to reinvest afterward; and, the subscriptions that trigger the rebalancing process do not represent too high a percentage of the pooled entities. It falls within the fiduciary duty of the pooling operator to follow-up on the inflows and outflows of cash and make sure that the advantages that each pooled entity is getting from the pooling arrangement are greater than the inconvenience or increase in cost caused thereby, and, to establish compensating measures to ensure equitable treatment of participating funds.

In cases where the investment manager believes the situation is detrimental to one of the pooled entities, e.g. a very large subscription is forecasted into another pooled entity, it could decide to suspend the pooling arrangement or to invest the incoming cash outside the pooling arrangement.

Operational risk

Pooling increases the operational complexity of asset management, and therefore also necessarily increases operational risk. For example, in the case of virtual pooling, there is a risk that the complexity of reporting under different countries' GAAPs will result in reporting errors. And in the case of entity pooling, not only must the pool correctly report its portfolio transactions, but that information must also be passed through to the participating funds and correctly reported there as well.

However, both the UCITS Directive and the pending Capital Requirements Directive require asset managers to hold capital against their operational risks and vary that capital requirement in proportion, as those asset managers can demonstrate advanced risk management processes and procedures. Therefore, there is already an appropriate regulatory remedy to the operational risk, whether arising as a consequence of pooling or otherwise, and deep expertise in the management of operational risk in relation to virtual and entity pooling.

Corporate governance

Pooling increases the number of intermediaries between institutional investors (in this context, the participating funds) and their underlying investments. This can make it more complex to exercise voting rights, and therefore participate in corporate governance. However, the European Commission's recent consultation on shareholders' rights[21] would appear to provide an effective means of 'looking through' chains of intermediaries and reasserting the voting control of the underlying beneficial owner.

[21] Fostering an Appropriate Regime for Shareholders' Rights (MARKT/16.09.2004)

Investment Management Association

65 Kingsway London WC2B 6TD United Kingdom

Tel: +44 (0)20 7831 0898 Fax: +44 (0)20 7831 9975

www.investmentuk.org

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