

CONSOB-BANK OF ITALY

Working Group  
on

*“Possible perspectives on centralized deposit and  
rationalization of fund processing in Italy”*

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## INTRODUCTION

In August 2008 CONSOB and the Bank of Italy set up a joint Working Group on the “dematerialisation of funds” to respond to the need for greater efficiency and competitiveness in the Italian asset management industry.

The substantial net outflows recorded by funds in recent years reflect the structural problems in the asset management industry, recently aggravated by the illiquid position of the markets, which is the basis of the global macroeconomic crisis.

The crisis in this industry in particular has for some time been closely monitored by the supervisory authorities, which have examined the possible structural causes and, amongst others, have identified the relative lack of strategic independence of banking-group-owned asset management companies and the consolidation of vertical production-distribution integration models.

Points to consider on the asset management industry’s outlook had previously been published in *Quaderno di Finanza* no. 61, January 2008 as “*The marketing of Italian mutual funds – Post-MiFID organisational models, costs, performance and new prospects from the point of view of supervision*” (hereinafter also referred to as: “*Quaderno di Finanza*”).

This *Quaderno* illustrated the opportunities offered by the new post-MiFID regulatory framework (Italian Legislative Decree 164/2007 and CONSOB Regulation no. 16190/2007) to increase the diversification of fund marketing channels and to pay greater attention to investor needs in selecting intermediaries and services

In this context it was seen that there was a need for further study on the option of introducing a central depository system for the dematerialisation of open-end fund units.

At the same time, the *Quaderno* illustrated that the new EU provisions make the customer central, whose interests are to be served by the investment services provided, emphasise the configuration of services around customer needs (from advisory services to receipt of orders for ‘execution only’), recommend that service-based payments be covered by a contract, and govern direct and indirect remuneration methods.

The lines of thought followed in the *Quaderno di Finanza* caught the attention of market operators, particularly the prospect of central depository services for the dematerialisation of open-end fund units.

The topic was brought up again in the Final Report of the Bank of Italy round table on the asset management crisis, as the line of action that could lay down the foundations for the creation of multiple distribution models with variant costs inherent in the system infrastructures, and in the CONSOB Chairman’s speeches to the financial market.

The importance of the topic covered by the Working Group required the involvement not only of supervisory authority representatives, but also representatives of both the fund production and distribution sides of the main associations involved in the asset management industry (see *Annex 1 – List of participants*).

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This paper illustrates the studies conducted by the Working Group on central depository systems for the dematerialisation of open-end fund units and the conclusions reached.

Specifically, **Chapter 1** contains the purpose and objectives leading to the creation of the Working Group and the working methods adopted.

**Chapter 2** covers the main provisions on the matter, which make up the current regulatory framework.

**Chapter 3** illustrates the models and operating processes for investor order execution with regard to units of collective investment undertakings (UCITS), first describing existing models, from vertical integration to “few to many”, and then the various operating scenarios, from the overall system involving the standardisation of information flows between management companies, sales networks and custodian banks to the central depository system for units of UCITS.

**Chapter 4** provides the details on the results of the cost-benefit analysis performed by the Working Group on the introduction of both the above-mentioned operating scenarios.

Lastly, **Chapter 5** draws conclusions from the Working Group’s studies and the most important “next steps” to be taken.

This Paper has been published on the CONSOB and Bank of Italy web sites.

## CHAPTER 1 – The Working Group

### 1.1. Working Group purpose and objectives

#### *Purpose*

The Working Group was set up to study regulatory and operating aspects for the purpose of conducting cost-benefit analysis for a central depository system for the dematerialisation of open-end mutual funds.

This is particularly important for the standardisation of operating flows between management companies, distributors and custodian banks, which could become necessary on implementation of a central depository system.

#### *Objectives*

The specific task of the Working Group was to verify:

- whether any “system” solutions, by eliminating certain “operating” barriers, could contribute to expanding the strategic options of distributor intermediaries, in support of differentiated competitive positioning. This in consideration of the fact that such a solution, in compliance with the freedom of supervised persons to opt for the distribution method believed to be most efficient, might simplify access to all the organisational options offered by the new regulations on investment services;
- whether a convergence of “system” solutions – for example, a central depository system for the dematerialisation of open-end fund units – might in the long term offer economies of scale and scope for the asset management industry. This given that the management companies could make use of a shared infrastructure to manage the fund processing stages and concentrate more on aspects of the production process offering higher value-added services to the financial system and to investors, such as product design and portfolio management;
- whether operating flow standardisation system might simplify the portability of open-end fund units, in a similar manner to other financial instruments such as shares, for retail customers.

The “path” to financial system efficiency and competitiveness could pass through verification of the conditions underlying the success of a central depository system for dematerialisation, acting as a kind of system “architecture” for all those involved in the open-end fund production and distribution process (managers, distributors, custodian banks), allowing managers to concentrate more on “production” by increasing the quality of supply and distributors to focus on “advice” on the best investment options for their customers.

## 1.2. The methods adopted

### *Industry involvement*

The approach adopted by the Working Group took into consideration the contributions of various members of the asset management industry, in addition to a number of Italian and international central depositories.

Representatives of the industry's financial associations involved in the open-end fund production and distribution process were regular participants in the Working Group, and the meetings also saw the regular attendance of members of asset management companies, distributors, custodian banks and central depositories, all as experts on operating matters of particular importance to the Working Group's objectives (see *Annex 2 – List of persons consulted*).

The works were jointly co-ordinated by CONSOB and the Bank of Italy.

### *Working methods: regulatory and operating profiles*

The first meeting of the Working Group, on 1 October 2008, discussed the objectives to be achieved, the working methods and the calendar.

It was also agreed at the first meeting to perform a preliminary identification of the regulatory profiles on UCITS, investment services and central securities depositories, and to analyse the operating profiles, if necessary with help offered by experts at special hearings.

In particular, the identification involved the existing regulatory framework on investment in mutual funds and the “management” of related funds, and on a central depository system for dematerialisation. The operating profiles of the central depository system for the dematerialisation of open-end fund units were examined also in comparison with the experience of other countries.

The Working Group then believed it was important, after outlining the possible legal and operating solutions, to perform a cost-benefit analysis of the central depository system for dematerialisation to assess the presumable impact of its introduction.

In this respect, a small sub-group of Working Group members was assigned to conduct interviews with targeted industry operators to obtain information specifically for the cost-benefit analysis (see *Annex 3 – List of persons interviewed for the cost-benefit analysis*).

The studies completed by the Working Group were formalised in internal papers with the aim of stimulating liaison among members.

## CHAPTER 2 – The regulatory framework

### *Identification of reference regulations*

### **2.1. Introduction**

To verify the impact that the introduction of “system” solutions – e.g. central depository system for dematerialisation of open-end fund units – might have on current regulations, a preliminary identification of the regulatory profiles was performed.

Specifically, three reference regulatory areas were identified (“collective management”, “investment and ancillary services” and “central depository services for dematerialisation”); for each, the focus was on provisions of particular relevance to the Working Group’s objectives.

The idea was to provide a “snapshot” of the various production and distribution stages of open-end funds (i.e. the service chain) that would be affected by the introduction of a central depository system for dematerialisation.

With regard to the various operating situations seen in practice (e.g. outsourcing of processes or process stages), the execution of these stages can vary: from the issue and redemption of open-end fund units, with implications in terms of their management and the registration and reporting of orders, to the fund distribution stage in which order and payment transmission and investor contact are highlighted, and to the central depository system for dematerialisation, with an indication of the activities performed (or potentially performed) by a central depository.

The identification of service chain regulations allows evaluation of how the solutions studied by the Working Group might affect the current regulatory framework.

### **2.2. Current regulations**

#### ***2.2.1. The existing regulations on collective investment management***

Identification of the provisions on collective management was conducted with reference to regulations on Italian and on harmonised non-Italian UCITS.

In identifying the provisions relevant to the Working Group’s objectives, the current differences between Italian UCITS regulations and the rules on harmonised non-Italian UCITS were considered, with reference to the profiles for product marketing, fund unit subscription and redemption, and “management” (“combined” certificates and the role of the custodian bank, the option of issuing individual certificates).

These differences mostly derive from the fact that these UCITS are governed by different laws.

The process was intended to pinpoint the common regulations concerning those aspects.

***Regulations on Italian open-end funds***

The regulations on collective investment management are contained in Italian Legislative Decree no. 58 of 24 February 1998 (the “Consolidated Law on Finance”),<sup>(1)</sup> and the implementing provisions are dictated by the Italian Ministry of the Economy and Finance, CONSOB and the Bank of Italy<sup>(2)</sup>.

Given the purpose of the Working Group, the most important rules are those regarding the issue and redemption of open-end mutual funds and the role played by companies responsible for establishing and managing the funds, custodian banks and distributors.

In this respect, art. 1, subsection 1, paragraph k) of the Consolidated Law on Finance classifies mutual funds<sup>(3)</sup> as “open-end” when “investors have the right to request, at any time, to redeem units in accordance with the procedures established by the rules of the fund”.

These characteristics mean that the lack of an additional (and/or substitute) market beyond the issue market for open-end fund units, unlike other financial instruments, is irrelevant.<sup>(4)</sup> For this reason, open-end fund units are normally issued at the time of subscription and cancelled when their holders claim redemption<sup>(5)</sup>.

***The “management” of open-end fund units: the combined certificate***

In accordance with art. 36, subsection 8 of the Consolidated Law on Finance, investment units of mutual funds are represented by registered or bearer certificates, as the investor prefers. The same provision states that, after consulting CONSOB, the Bank of Italy can in general establish the certificate characteristics and the initial unit par value.

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<sup>(1)</sup> See art. 33 et seq., Consolidated Law on Finance.

<sup>(2)</sup> Specifically, reference is mainly to Italian Treasury Decree no. 228 of 24 May 1999 on the characteristics of mutual funds, CONSOB regulations adopted by Resolutions 16190/2007 and 11971/1999 on intermediaries and issuers respectively, the Bank of Italy Regulations of 14 April 2005 on collective investment management and the joint CONSOB-Bank of Italy Regulation of 29 October 2007 on organisation and procedures for financial intermediaries.

<sup>(3)</sup> Along with SICAVs, mutual funds are classed as UCITS pursuant to art. 1, subsection 1, paragraph m) of the Consolidated Law on Finance.

<sup>(4)</sup> Units of mutual funds are classed as financial instruments under EU law, as per section 4, subsection 1.17 and Annex I, Section B.10 of Directive 2004/39/EC (MiFID).

<sup>(5)</sup> Art. 5, Italian Treasury Decree 228/1999 states that: “1. The fund regulations indicate whether listing on a regulated market is envisaged for certificates representing the fund units. 2. Application for listing is compulsory for closed-end funds which require a minimum subscription of less than twenty-five thousand Euro. 3. For the listing of closed-end funds, the application for admission to trading of the units must be submitted by the asset management company within twenty-four months of closure of the subscription period”.

In addition to defining the characteristics of fund certificates, the Bank of Italy Regulations of 14 April 2005 on collective investment management<sup>(6)</sup> offer management companies the option, as an alternative to individual certificates, of recourse to “combined” certificates representing multiple units. This certificate is held free of charge on a securities deposit account by the custodian bank<sup>(7)</sup>, with separate records for individual investors, if need be grouped according to the distributor involved. An investor may request the issue of an individual certificate at any time. These provisions do not apply to dematerialised fund units, pursuant to Italian Legislative Decree no. 213 of 24 June 1998.

***Execution methods  
for subscription and  
redemption  
transactions***

Subscription and redemption transactions regarding units of open-end funds are mainly governed by Italian Treasury Decree 228/1999 and the Bank of Italy Regulations of 14 April 2005 on collective investment management<sup>(8)</sup>.

Without prejudice to management company independence in the drafting of fund regulations, the aforementioned ministerial decree states that the subscription of open-end fund units must be by payment of an amount corresponding to a specific number of units determined according to their value, calculated at least on a weekly basis. Redemption transactions must be completed by at most fifteen days following the date of claim, though execution may be suspended under certain circumstances.

The above-mentioned Bank of Italy Regulations specify the terms (valuation date of the unit issued or redeemed, transaction settlement date, etc.) that must be observed in transactions involving the subscription or redemption of investments in fund units<sup>(9)</sup>.

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<sup>(6)</sup> See Title V, Chapter VI of the Bank of Italy Regulations in question.

<sup>(7)</sup> According to current regulations (art. 36 subsection 2 and art. 38 of the Consolidated Law on Finance; Title V Chapter VII of the 2005 Bank of Italy Regulations), the custodian arranges custody of the financial instruments and the fund’s cash assets, confirms the lawful nature of issue and redemption transactions on units of open-end funds and the allocation of related proceeds, confirms that the fund unit value calculation is correct or performs this calculation if asked to do so by the management company, confirms that in fund management transactions the return service is charged back to the custodian in the terms of use, and acts on instructions from the management company unless the instructions prove unlawful.

<sup>(8)</sup> See Italian Treasury Decree no. 228 of 24 May 1999 (section. 10) and Bank of Italy Regulations of 14 April 2005 on collective management (Title V, Chapter I).

<sup>(9)</sup> In particular, it is envisaged that: i) for subscription transactions, the fund regulations must indicate the unit valuation date taken into consideration in calculating the number of units allocated to each subscription (the “reference date”). The reference date is the date on which the management company received confirmation of the subscription by the cut-off time indicated in the regulations. Transaction settlement must take place by the end of the day after the reference date. In addition, current regulations allow the fund to be offered in association with other financial services or products (e.g. insurance policies) or linking of a fund to a liquidity account; ii) redemption must be at the value per unit on the date of management company receipt of the claim for redemption. The regulations must also specify the criteria for identification of the date of receipt, also indicating the cut-off time by

***Registration and reporting obligations***

Lastly, as envisaged in the joint CONSOB-Bank of Italy Regulation of 29 October 2007, for each subscription or redemption transaction completed the asset management company must arrange electronic registration - by the end of the day after receipt - of orders received from investors, and by the end of the day after execution must record the conditions under which the orders are completed. These obligations can also be met through the distributors<sup>(10)</sup>.

In investor relations, the asset management company and fund distributors must also make arrangements for the prompt issue, in permanent format, of basic information regarding the execution of subscription and redemption orders (art. 53 and art. 74, CONSOB Regulation 16190/2007 on intermediaries). The distributors play an important role in this context, given their direct contact with the investors.

***Harmonised non-Italian UCIs marketed in Italy***

Subscription and redemption transaction procedures and the role of the various players in the production and distribution process of open-end funds were also examined by the Working Group in relation to provisions governing harmonised non-Italian UCITS marketed in Italy and targeting retail customers.

The above-mentioned Bank of Italy Regulations of 14 April 2005 on collective investment management contain specific rules for marketing units or shares of harmonised non-Italian UCITS in Italy<sup>(11)</sup>.

In particular, the regulations state that for harmonised non-Italian UCITS the offerors shall adopt organisational models that include at least one payment agent (which amongst other things provides payment intermediation services in relation to the issue and redemption of fund units and harmonised UCITS accounts) and at least one investor relations agent (amongst other things responsible for administrative tasks regarding subscription and redemption claims).

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which the claim must reach the management company. The investor is always offered the option to submit a direct claim for redemption to the asset management company, without the need to operate through the placement agent. If envisaged in the regulations, switch transactions are also permitted for transfer from one fund to another. Lastly, if the redemption claim is for a significant amount or shortly after subscription, the fund regulations must allow for calculation of the redemption value by non-standard methods if necessary for the protection of other investors.

<sup>(10)</sup> See art. 44 and Annex 3 of the joint regulation. Registrations must contain certain information that cannot be changed, i.e. basic details of the investor issuing the subscription or redemption order, the date, time and type of order, the net asset value attributed, the number of units, the gross amount paid and the net amount invested. With regard to subscription and redemption registrations, the management companies may opt to indicate only the fund unit placement agents, retaining the option of asking the placement agents to “decode” the information to identify the individual investors. The keeping of the subscriber register may also be outsourced (to the placement agents, for example), provided this does not result in any assignment of liability by the asset management company, relations and obligations to the investors are not altered and, in any event, monitoring of the outsourced activities is ensured.

<sup>(11)</sup> See Title VI, Chapter V and Annex VI.5.2 of the 2005 Regulations.

It should also be considered that the execution of subscription and redemption orders involving units of harmonised non-Italian UCITS involves persons operating in the product's home country. In addition to the management company and custodian bank, an important role is played by the registrar (responsible for keeping the register of investors in shares or units of UCITS), the transfer agent (which prepares the subscription, redemption and switch claims and handles investment-related disclosures) and the UCITS administrator (responsible for calculating the value of UCITS units or shares). The duties of the registrar, transfer agent and administrator can be performed by the same person.

Subscription claims are normally collected by harmonised non-Italian UCITS by the "nominee" method, which in line with art. 21, subsection 2 of the Consolidated Law on Finance allows the distributor and/or investor relations agent to submit subscription orders in aggregate form to the manager or its agents for unit issue and valuation purposes.

Lastly, it should be noted that capital gains tax on investments in harmonised non-Italian UCITS is withheld by the resident payment agent with regard to periodic income and unit redemption proceeds. Note also that with regard to payment agent duties the harmonised UCITS and custodian bank – if they have no branch in Italy for this purpose – must make use of a bank based in Italy to make arrangements for subscription and redemption transactions and related payments<sup>(12)</sup>.

### ***2.2.2. Regulations on investment and ancillary services***

#### ***Regulations on investment and ancillary services***

The regulations on investment and ancillary services have changed considerably since the introduction of the MiFID, which was implemented in Italy through amendments to the Consolidated Law on Finance and new supervisory provisions on regulatory levels (CONSOB Regulation no. 16190 of 29 October 2007 and the joint CONSOB-Bank of Italy Regulation of 29 October 2007).

The new regulations offer a number of models for the distribution of financial products (including open-end funds), with options remaining open to the providers (product issuers) on the one hand, and distributors on the other, for wide-ranging independence in defining strategic policy to adapt the corporate structure and related operating procedures to the changes in the regulations. Management companies have the option of arranging direct marketing of their funds or funds of third-party providers.

#### ***Classification of rules of conduct***

There is now a clear differentiation and classification of the rules of conduct for intermediaries as regards services and types of customer. In

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<sup>(12)</sup> Bank of Italy Regulations of 14 April 2005 on collective management (Title VI, Chapter V, paragraph 1.3).

fact, on the one hand there are portfolio management and investment advisory services – the latter now classified as services requiring authorisation and with a wider range – and on the other hand services involving the execution of customer orders. The different role played by the intermediary, from the point of view of EU law, justifies strong customer protection for the first set of services and a gradually weakening protection for the others.

In line with EU sources, CONSOB Regulation 16190/2007 (Book III, Part II, Title II) illustrates the “know your customer” rule and subsequent intermediary valuation of the transactions to be made on customer accounts in relation to the type of investment service involved and its characteristics, calling for in-depth knowledge of the customer and a suitability assessment of the higher value added services (investment advice and portfolio management), or more limited knowledge of the investor and therefore an appropriateness assessment in the event of provision of other reserved activities (order execution, order receipt and transmission, placement).

Given these conditions, as envisaged in EU regulations (section 19, paragraph 6, Level 1 Directive 2004/39/EC) and implemented in Italy (art. 43, CONSOB Regulation 16190/2007), intermediaries can also perform ‘execution-only’ order execution and “order receipt and transmission” services, for which it is possible to dispense with customer knowledge. In this respect, note that the MiFID (section 19, paragraph 6) states that ‘execution only’ can also apply to harmonised UCITS.

For suitability assessment purposes, the new system (art. 39, CONSOB Regulation 16190/2007, in compliance with MiFID section 19, paragraph 4) requires that “necessary information regarding a) suitable investment awareness and experience of the type of instrument or service involved; b) the financial position; c) the investment objectives” are obtained from the customer.

Vice versa, for “execution” services the intermediary’s appropriateness assessment is limited to verification that the customer’s level of expertise is sufficient to understand the risks associated with the investment decision to be made.

In terms of greater value added offered to customers and investor protection, the supply model for investment services provided by the intermediary can legally include the combination of advisory services and “execution” services, consequently leading to the need for intermediary compliance with the stricter rules of conduct, also in terms of “customer knowledge” typical of investment advisory services<sup>(13)</sup>.

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<sup>(13)</sup> Specifically, given the wider concept of advisory services, CONSOB has indicated (see guidance of October 2007) that “in abstract terms, the provision of placement services or order receipt and transmission services (or order execution or own-account trading) without accompanying advisory services is not excluded. Nevertheless, the intermediary is required to implement mechanisms (contractual, organisational, procedural and control) as appropriate to ensure that collaborator and employee contact with customers complies with predefined relational models on the assumption that,

*Intermediary-  
customer  
relations*

Furthermore, it should be noted that the new MiFID-related regulatory context has led to substantial modification of the distributor-customer relational model, including the direct marketing of funds by management companies. In strictly legal terms, it should in fact be emphasised that, unlike the requirements of the previous reference framework, the distributor:

- must arrange contractual cover for its relationship with customers. Under previous regulations the customer's "mere subscription" to the product was allowed, but the new regulations call for a formal service contract, binding for both distributor and customer;
- may receive incentives from a non-customer only under the terms of art. 52, CONSOB Regulation 16190/2007<sup>(14)</sup>.

For the distribution of open-end funds, intermediaries are also expected to comply with investor disclosure obligations (with regard to fund characteristics and costs, what happens on acceptance of the prospectus<sup>(15)</sup>) and to abide by commitments to the management company (e.g. the transmission of orders and means of payment for unit subscription and redemption claims – also in aggregate format, and keeping of the subscriber register<sup>(16)</sup>).

*The securities  
dossier*

Lastly, for the purpose of the studies conducted by the Working Group, the regulations (also in contractual terms) and practices applied in the opening and closure of securities dossiers and their transfer to another intermediary chosen by the customer are relevant. The Bank of Italy Regulations of 14 April 2005 on collective management provide that open-end fund regulations must include the commitment and liability of asset management companies to ensure that appointed distributors do not hold customers liable for obligations and costs in addition to those envisaged in the fund regulations, for example the requirement to hold a deposit account for unit investments indicated in a combined certificate<sup>(17)</sup>.

Under the post-MiFID regulatory framework, it should in any event be remembered that intermediaries – and asset management companies that market funds directly - are required to comply with specific

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in effect, (...) the risk that activities performed results in presenting a given financial instrument as suitable for that customer (especially if non-automatic forms of contact are adopted) can be considerable, therefore integrating with "investment advisory services".

<sup>(14)</sup> Pursuant to art. 52, CONSOB Regulation 16190/2007, an incentive received from a non-customer other than "adequate compensation rendering provision of the investment services possible or necessary for this purpose" may be received by the intermediary only if: a) the customer is made fully aware of the incentive; b) it increases the quality of service provided to the customer; and c) it does not inhibit the company's obligation to serve the best interests of the customer.

<sup>(15)</sup> See art. 33, CONSOB Regulation 16190/2007.

<sup>(16)</sup> See Paragraph 2.2.1 above.

<sup>(17)</sup> See Title V, Chapter I, Section II of the Bank of Italy Regulations in question (paragraph 3.3.2).

customer disclosure obligations, also with regard to the provision of financial instrument custody and administration services<sup>(18)</sup>.

### ***2.2.3. The regulations on central depository services for dematerialisation***

Central securities depositories for financial instruments are not harmonised at European level, and under Italian law are reserved to specially-authorised public limited companies that meet specific equity and organisational requirements (art. 80, Consolidated Law on Finance).

#### ***Regulations on central securities depositories for financial instruments***

The Consolidated Law on Finance governs the conditions under which CONSOB, in agreement with the Bank of Italy, may authorise a central depository system, the terms for provision of such services and related supervision to guarantee transparency and investor protection (CONSOB) and system stability and risk containment (Bank of Italy)<sup>(19)</sup>. In particular, art. 81 subsection 2 requires that central depositories adopt service regulations that specify the services and the methods for their provision.

#### ***Central depository activities***

The service regulations therefore play a fundamental role in determining the range of operations of a central depository. The regulations envisage that the central depository system serve issuers and intermediaries. With regard to the issuers, this allows the issue of instructions for crediting financial instruments deriving from placement and for managing the related corporate transactions. A central depository system allows intermediaries to manage financial instruments, collect accrued dividends, interest and capital reimbursement, exercise other equity rights relating to the financial instruments and comply with tax requirements.

The central depositories may also provide the ancillary and instrumental services indicated in art. 9, subsection 1 of the CONSOB-Bank of Italy Measures of 22 February 2008<sup>(20)</sup> on central depository, settlement, guarantee systems and related management companies (the “Consolidated Measures”). In addition, such companies may organise

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<sup>(18)</sup> See Book III, Part II, Title I, Chapter I and Title VI, CONSOB Regulation 16190/2007.

<sup>(19)</sup> See art. 81 et seq., Consolidated Law on Finance.

<sup>(20)</sup> Relating in particular to the following activities: “a) the preparation, management, maintenance and marketing of software, hardware and computer networks for data transmission systems; b) the processing, distribution and marketing of data on financial instruments and data regarding the services managed; c) image promotion of the central depository and the service managed, and all other activities related to its development; d) the implementation of securities lending transactions for own account purposes and on behalf of third parties; e) the provision of management services for guarantees issued on financial instruments held by the central depository”.

## *Dematerialisation*

and manage settlement services together with ancillary and instrumental services<sup>(21)</sup>.

The regulations regarding the terms for admission of financial instruments (including Italian or non-Italian UCITS units or shares) to a central depository system for dematerialisation are essentially covered by Italian Legislative Decree no. 213 of 24 June 1998 (the Euro Decree) and by the Consolidated Measures.

According to the Euro Decree<sup>(22)</sup>, a central depository system for dematerialisation is compulsory for financial instruments traded or to be traded on regulated markets. Art. 28 subsection 2 of the Decree empowers CONSOB, in agreement with the Bank of Italy, to supervise situations whereby a central depository system for dematerialisation is made compulsory for other classes of financial instruments (“mandatory dematerialisation by order”), envisaging that, in exercising this power, CONSOB must assess the extent of distribution among the public of the financial instruments to be “dematerialised”.

Lastly, in compliance with art. 28 subsection 2 of the Euro Decree, the Consolidated Measures require the dematerialisation of financial instruments with at least one of the following characteristics:

- a) traded or to be traded on multilateral trading facilities with the consent of the issuer;
- b) limited to certain classes of financial instruments<sup>(23)</sup>, the issuer has other instruments listed on Italian regulated markets or is included in the list of issuers of widely-distributed financial instruments<sup>(24)</sup>;

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<sup>(21)</sup> Relating in particular to the following activities: “a) management of reconciliation and adjustment systems for transactions involving financial instruments; b) management of systems to guarantee the success of transactions involving non-derivative financial instruments and systems to guarantee successful clearance and settlement of transactions involving non-derivative financial instruments, provided this does not per se involve liability for transactions to be settled; c) allocation of loans, also intraday in Euro or other currency, and in financial instruments, for issue to persons authorised to perform settlement services, based on adequate guarantees and for the purpose of allowing such persons to settle their respective positions; d) management of accounts in Euro or other currency opened by persons authorised to perform settlement services, in compliance with the provisions of article 11 of the Consolidated Law on Banking regarding savings deposits from customers”.

<sup>(22)</sup> See art. 28, subsection 1. Also see art. 16, subsection 3 of the Consolidated Measures.

<sup>(23)</sup> These are shares and other equity securities for trading on the equity market (even if issued by cooperative banks), bonds, government securities and other debt securities for trading on the equity market, and units of mutual funds. With regard to fund units, this is in effect a printing error given that in referring to “the financial instruments indicated in article 11, subsection 1” reference was incorrectly made to “points a), b) and c)” rather than to points a), b) and e). After the entry into force of art. 16, subsection 4 (in February 2008), the error was not corrected as it was decided to study the question of centralised depository services for the dematerialisation of fund units as part of the Working Group activities.

<sup>(24)</sup> See art. 116 of the Consolidated Law on Finance and art. 2-*bis* and art. 108 of CONSOB Regulation no. 11971 of 14 May 1999 (the Issuers’ Regulation).

- c) limited to bonds and debt securities, the value of the issue exceeding 150 million Euro.

Issuers may also opt for voluntary dematerialisation of own-issue financial instruments<sup>(25)</sup>.

In any event, for each issue of financial instruments subject to dematerialisation a single central depository must be selected (art. 29, Euro Decree).

Asset management companies may be admitted to central depository services in the dual role of depositing party, with regard to portfolio management and collective investment management services<sup>(26)</sup>, and as the issuer of units of mutual funds.

However, if traded or to be traded on Italian regulated markets (for example, Exchange Traded Funds<sup>(27)</sup>), mutual fund units are subject to mandatory dematerialisation through central depository services, pursuant to article 28, subsection 1 of the Euro Decree, whereas if not traded and there are no plans for listing (e.g., Italian open-end funds) they may be admitted to central depository services for dematerialisation at the request of the issuer.

In addition, secondary regulations differentiate the scenarios in which mandatory dematerialisation is required either subsequent to or simultaneously with the issue of the investment units <sup>(28)</sup>.

Regulations on central securities depositories for financial instruments also envisage certain disclosure obligations and commitments by the intermediaries with regard to issuers, in relation to restrictions placed on registered financial instruments and the exercise of rights (corporate or equity) related to the centralised instruments.

### ***Settlement services***

Regulations on settlement services are provided in the Consolidated Law on Finance and in the Consolidated Measures. The Consolidated Measures require that data on individual transactions to be settled be transmitted to the settlement services company after reconciliation by the intraday reconciliation and adjustment systems; that the management company take all measures necessary to ensure the final intraday terms for settlement and in any event shorten the period between acquisition/processing of the data on transactions to be settled and their settlement date to a minimum; that the settlement services company adopt service organisation measures that reduce the number of

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<sup>(25)</sup> See art. 28, subsection 3 of the Euro Decree and art. 16, subsection 5 of the Consolidated Measures.

<sup>(26)</sup> See art. 12, CONSOB-Bank of Italy Measures of 22 February 2009.

<sup>(27)</sup> In this respect, it should be emphasised that non-Italian ETF units or shares currently traded on Borsa Italiana's screen-based market for funds are subject to mandatory centralised depository services for dematerialisation.

<sup>(28)</sup> See articles 37, 38 and 39, Consolidated Measures.

transactions pending settlement to a minimum and guarantee prompt closure of settlement also in the event of default of one or more authorised members. Specific regulations on the provision of settlement services are envisaged to ensure compatibility with the Target 2 system<sup>(29)</sup>.

Lastly, authorisation for the management of settlement services may only be granted to a central depository, or to a subsidiary based in Italy of persons operating a central depository system, Italian or non-Italian, provided they are subject to supervision equivalent to that envisaged under Italian law<sup>(30)</sup>.

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<sup>(29)</sup> See articles 47, 48 and 49, Consolidated Measures.

<sup>(30)</sup> See article 41, Consolidated Measures.

## CHAPTER 3 – Underlying operating procedures in fund distribution models

### 3.1. Introduction

Improving the efficiency and competitiveness of the asset management industry depends on removing operating barriers in current fund distribution models.

The existence of operational impediments to the creation of a highly competitive funds market, in fact, does not help financial system development and does not allow sufficient investor protection.

This Chapter will describe the operational processes for management of the subscription and redemption cycle adopted in the distribution models for open-end mutual funds (or Sicav shares)<sup>(31)</sup>, and those that could be implemented in the future.

Specifically, a description will first be given of:

*Subscription and redemption-related processes*

*a) existing processes*

- the operational process in the vertical integration model – used mainly for the distribution of Italian funds in Italy – based on integrated platforms adopted by the companies of a group;
- the few-to-many operational process – mainly used for the distribution of non-Italian funds in Italy – based on multiple relations between members of different corporate groups and making use of different platforms in a more advanced flow integration logic.

*b) processes that could be implemented*

An illustration will then be provided of **processes that might be used in the future**, i.e.:

- information flow standardisation between operators at the various stages of distribution;
- a central depository system for open-end fund units.

The processes are illustrated to highlight their strengths and weaknesses, with particular regard to their restrictions and potential offered to industry operators.

### 3.2. The current vertical integration distribution model

*Intragroup logic*

The model of vertical integration between asset management company and distributors is used almost exclusively by distributors that belong to

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<sup>(31)</sup> For the sake of simplicity, further reference will be to open-end mutual funds only; in which case the reference should be taken to also include Sicav shares.

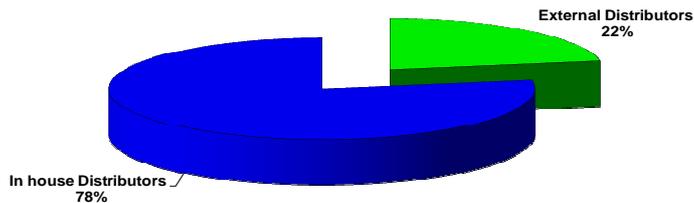
***Implementation  
on the Italian  
market***

the same group as the asset management company (i.e. in-house distribution).

This is the most common model for Italian funds in Italy, owing to the relative lack of independence of asset management companies from their parent groups.

Supervisory data shows that approximately 78% of commission expenses paid by asset management companies for the distribution of open-end funds that the asset management companies have created and are managing, goes to group-member companies (see fig. 1).

***Fig. 1: commission expense payees as at 31 December 2008, with breakdown based on membership or otherwise of the same Group as the provider.***



Among the group distributors there is a prevalence of banks (commission expense paid by asset management companies to banks accounts for 68.5% of the total).

In this business integration logic, the relationship between asset management company and distributor seems to be tilted in favour unbalanced in favour of distribution. It follows that:

- investment management, instead of focusing solely on value generation logic, is in most cases an instrumental service in the product supply capacity of the banking groups, i.e. in the commercial choice of distributors;

- the distribution policies of distributors could underrate customer needs, given the predetermined objectives of satisfying the *integrated* interest in sales (between provider and distributor).

Note that the business model of vertical integration between production and distribution, which initially facilitated the growth of the asset management industry, does not spur competitiveness, and consequently affects the development and quality of management services. In this context, open-end mutual funds offered to the public have been subject to pressure from rival products, even within the same class. Clear examples are the dissemination of listed index funds accessible through trading services, aggressively priced, and the increase in surrogate products such as insurance policies and bank bonds.

### ***3.2.1. The operational process for investor order execution***

The operating mechanism for the execution of investor orders under vertical integration consists in an exchange of information flows between distribution process operators – largely within the same group, as noted – based on the use of integrated communications platforms.

**The various fund processing stages are completed in-house by the management company or by the administrative outsourcer that performs customer back office tasks.**

Next let us show the direction of these information flows, followed by an analysis of the type of relations implied.

With regard to the **execution of subscription and redemption orders**, the steps are: 1) data acquisition for orders by the asset management company; 2) order processing (also including their valuation, i.e. calculation of the number of units corresponding to the amount subscribed or redeemed); 3) transmission to the custodian bank of flows required to perform payment intermediation and updating of the register of combined certificates; 4) registration of the subscription and redemption orders.

In general, **the distributors arrange transmission of the order (for subscription or redemption) received from investors to the asset management company<sup>(32)</sup>.**

### ***Subscription and redemption***

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<sup>(32)</sup> In fact, despite the fact that investors may send subscription applications directly to the asset management companies, **direct placement** by the asset management company/SICAV continues to have a residual impact on the total distributed (in 2008 the total distributed directly by asset management companies was approximately 10% of total assets distributed). However, asset management companies still retain in-house control of the receipt and processing of any applications received directly from customers. This is true particularly as redemption claims may be issued directly to the asset management company, regardless of the fund placement method.

**Regarding the distributor transmission method and timing of orders to the asset management company**, note that the distributors mostly use automated methods and comply with the deadlines laid down in the fund regulations (which specify that distributors must forward the subscription application and related means of payment to the asset management company by the end of the day after receipt of instructions from customers).

Following capture of the order data, the asset management company arranges *processing* through the customer back office<sup>(33)</sup>. The order processing stage first of all involves calculation of the number of units corresponding to the amount subscribed or to be redeemed (the *valuation* step), net of fees.

Subscriptions are valued at net asset value (NAV) for the date on which the management company received confirmation of the subscription, by the time established in the fund regulations (the “reference date”)<sup>(34)</sup>.

**The order processing stage consists in the management company’s transmission to the custodian bank of information flows required for payment intermediation.** The bank also receives payment flows from the distributor and flows of credit to (for subscription orders) or debit on the fund account (for redemptions) for transmission to the distributor.

If the invested units are to be entered on the combined certificate held by the custodian bank, the bank updates the certificate records in compliance with the order details<sup>(35)</sup>.

Specifically, the combined certificate is held by the custodian bank, with separate records for individual investors, if need be grouped by distributor, in which case the custodian bank cannot immediately identify the investors, though this information can be obtained on request (for example, where the issue of an individual certificate is requested or at the time of unit redemption or on request to disaggregate the combined certificate).

Once the subscription (or redemption) order has been valued and settled, the asset management company goes on to comply with the related **registration obligations**. The register may include the name of

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<sup>(33)</sup> If this task is outsourced, after processing the subscription and redemption orders are forwarded to the person appointed to provide back office services.

<sup>(34)</sup> The *reference date* cannot be earlier than the value date recognised for the means of payment, and the amount of the subscription is attributed to the fund with the same value date as that recognised to the means of payment chosen by the subscriber. Redemptions are completed at the value per unit on the date of the management company’s receipt of the redemption claim or, if this is a day on which no unit valuation is performed, at the first value calculated thereafter.

<sup>(35)</sup> Unless the customer requests the issue of a printed registered or bearer certificate (which normally involves an additional cost to the subscriber), the units issued are included in the combined certificate held by the custodian bank.

the end investor or that of the distributor through which the end investor placed the order, provided the distributor holds confirmation records of the positions of individual investors.

**The subscription and redemption order execution process is normally completed within 2 or 3 business days**, given the time needed to transmit orders from the distributor to the management company, and for the latter to value and settle.

With regard to flow management, the *transfer* and *portability* of open-end fund units are fundamental.

#### *Unit transfer*

The **unit transfer process** implies a change of ownership.

Specifically, unit transfer between investors using the same distributor is different depending on whether the units are registered or bearer.

The circulation of registered units, unlike bearer units, has an immediate impact on the records in the investor register held by the asset management company. This distinction is irrelevant to combined certificates held by the custodian bank, for which any change results in updating of the combined certificate table of contents.

However, the transfer process of mutual funds units between investors is of residual significance because the system has no secondary trading market.

#### *Unit portability*

The **transfer process** has to be considered separately from **unit portability**, which involves an investor who decides to transfer UCITS units or shares from one distributor to another, with no change of ownership.

Execution of the portability process begins with the request from the investor, normally<sup>(36)</sup> to the distributor, to "move" his or her position to another intermediary. After due examination, the distributor then forwards the request to the management company.

In detail, the asset management company must first of all capture the *acceptance confirmation* from both distributors (new and old), required for reconciliation of the positions in records kept by the asset management company for each distributor<sup>(37)</sup>.

After receipt of the acceptance confirmations from both distributors, the asset management company – or custodian bank responsible for the administration and accounting of the fund – reclassifies the units within existing records from the old agent to the new distributor.

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<sup>(36)</sup> In effect, portability is currently governed only as part of distribution agreements, and fund management regulations do not envisage the submission of the request to the management company.

<sup>(37)</sup> In this respect note that, in effect, the management company does not create a new record as the fund units are still in the name of the same investor.

The custodian bank receives the unit reallocation notice through asset management company-custodian bank information flows and arranges updating of the combined certificate register.

For the distributors, portability requires them to update individual investor positions in their own records.

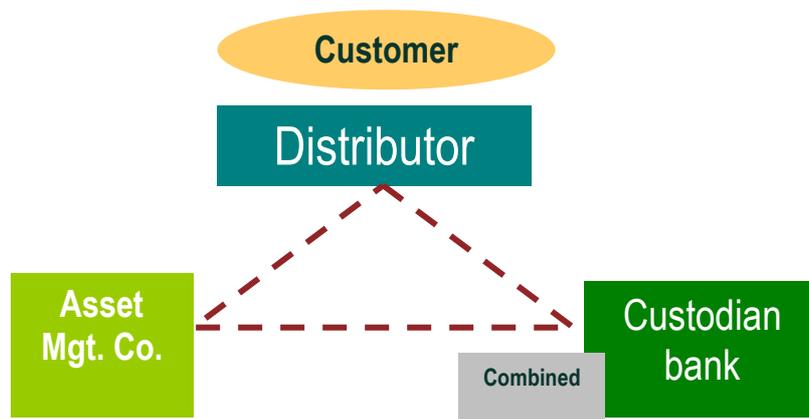
**Where both intermediaries are also distributors of the asset management company, the time needed for portability** is shortened, depending on whether or not the link between intermediaries and the asset management company is computerised. Normally, in fact, the shorter time to acceptance confirmation brings rapid execution.

**When one of the two intermediaries is not a distributor of the management company,** the process is different. In such cases the investor must personally inform the asset management company of the order to shift the units and may not operate through the intermediary that is not the distributor. The new distributor must then establish direct relations with the fund management company.

### ***3.2.2. Relations between distribution process operators and the organisational decisions of asset management companies***

As shown, investor order execution is based on the exchange of information flows between asset management companies, distributors and the custodian bank according to their **direct relations**, as shown in the figure below (*see fig. 2*).

***Fig. 2: Subscription and redemption order flows for Italian funds/SICAVs\*.***



*\* Note that the distributor-custodian bank link indicated in the figure only exists in cases where the custodian bank is appointed keeper of the subscriber register by the asset management company.*

For the exchange of information flows, members of the same group make use of **integrated communications platforms**.

In general, for each fund:

- 1 the asset management company uses platforms allowing communication with the distributors and custodian bank;
- 2 the presence of the custodian bank requires special platforms for communications with the fund management company on the one side and distributors on the other.

The integration of information flows can be achieved not only by ad hoc applications but also through **specific organisational decisions** to simplify and standardise the flows. In particular, many large management companies **outsource customer back office administrative tasks**. In this case the subscription and redemption flows received by distributors are channelled to the back office outsourcer rather than to the asset management company, so the establishment of relations with new distributors implies the need for a computer link to the back office appointed by the management company. Where customer back office tasks are performed by an outsourcer, it is the latter that keeps the investor register.

Lastly, the order execution process can be further simplified if the party to which back office tasks are outsourced is also the custodian bank, in any event also appointed to perform unit evaluation.

### ***Examples***

The scenario of a large Italian management company is used as an example of an integrated intragroup platform. With regard to the organisational profiles relevant to subscription and redemption order execution processes:

- 1) the management company has outsourced customer back office administrative tasks to the group's custodian bank;
- 2) this custodian bank performs NAV calculation on the funds.

In this context, the subscription and redemption orders deposited with the distributors are forwarded to the external customer back office, which arranges order processing through internal integrated information flows between the back office and NAV calculation departments.

For the direct marketing of mutual funds established and managed by an asset management company, the company arranges transmission of the subscription and redemption orders to the appointed customer back office.

### ***3.2.3. Strengths and weaknesses of the model***

The vertical integration distribution model frequently implies an operating process based on the use of integrated platforms and a group single entry point for order processing.

The single entry point, depending on the organisational setup adopted by the asset management company, coincides with either the provider or the company to which customer back office administrative tasks are outsourced.

The strength of this operating format lies in the economies of scale and scope that offer process optimization and cost abatement.

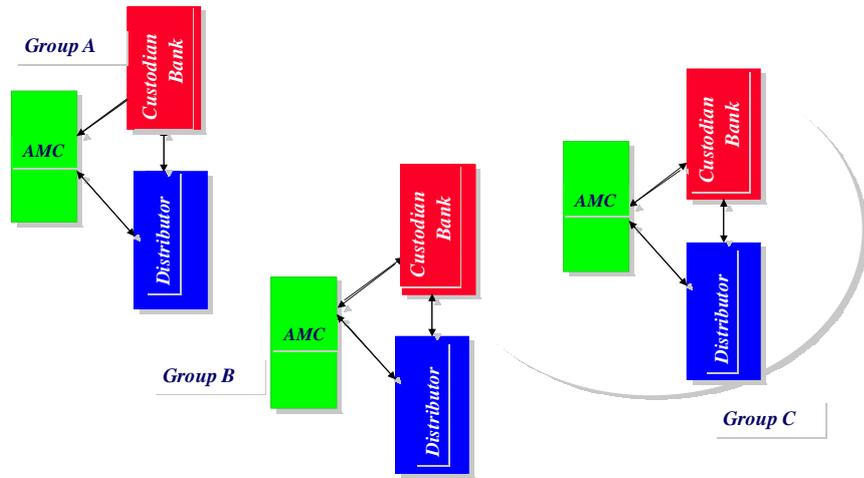
Internally, therefore, the system is seen as efficient, i.e. for the distribution process operators which as members of the same group can communicate through an integrated platform.

However, it is the very existence of an integrated intragroup platform (*see fig. 3*) that acts as a barrier to the establishment of new trade relations with non-group entities which, as such, cannot connect to the platform except to execute significant investments online.

Another weakness regards UCITS unit or share portability. These have very different characteristics depending on whether in-house distributors or a former in-house distributor in the provider's group and a new distributor external to that group are involved. In the latter case, in fact, an incentive exists for the former in-house distributor in the provider's group to help the customer to decide by illustrating alternatives to unit portability, thereby avoiding the switch to another intermediary (*see paragraph 3.3.2 below*).

The system could be organised as in the figure below, i.e. a series of "closed business" units with no link between them.

**Fig. 3:** illustration of a system based on vertical integration between providers and distributors



### 3.3. The “few-to-many” distribution model

#### *Intragroup logic*

The few-to-many distribution model is based on more extensive multiple relations between fund distribution process operators than in the vertical integration model.

#### *Implementation on the Italian market*

This model is recognised in Italy mainly in reference to non-Italian funds. The marketing methods for these funds on the Italian market, as established under current regulations, in fact envisage that in Italy harmonised non-Italian UCITS make use of a *local payment agent* and a *local investor relations agent* in addition to the distributors<sup>(38)</sup>.

Operating practices show that the organisational setup adopted by non-Italian UCITS to market their units or shares in Italy are characterised by:

- centralisation of the *local payment agent* and *investor relations agent* tasks into a single banking operator;
- the fact that selection of the *local payment agent* is the result of negotiations subject to the weight in terms of size of the contracting parties and the stickiness of relations with the groups behind the individual distributors.

<sup>(38)</sup> Note that the *local payment agent* controls the intermediation of payments linked to UCITS unit subscription orders, redemptions and income payments. The *local entity responsible for investor relations* controls the administrative side of subscription and redemption claims or the clearance of shares received from the placement agents, also arranging issue of the investment confirmation letter to the subscriber and delivery of the certificate representing the units or shares, if required.

It follows that, to market its units or shares in Italy, the same non-Italian UCITS could find itself in the position of having to use a series of local payment agents.

### *Examples*

Among the experiences emerging from consultation, let us mention the organisational models adopted by two leading European players that market their products in Italy.

One involves no fewer than **ten local payment agents**. However, the assets distributed are highly concentrated, with a full 80% of subscription orders flowing through just four agents. The second envisages at least **five local payment agents**. But again, there is strong concentration, with no less than 75% of subscription orders accounted for by just two agents.

The few-to-many model has also been applied for the distribution of Italian funds, specifically those established and managed by medium-sized management companies with a consortium-style setup and a large number of distributors, so that while it is certainly less important in this country than the vertical integration model, it nevertheless cannot be disregarded.

### *Example*

One medium-sized management company manages 26 UCITS, using 7 custodian banks and some 120 distributors (banks and asset management companies) with around 8,000 branches.

### ***3.3.1. The operational process for investor order execution***

The execution of investor orders under the few-to-many model involves the exchange of information flows between distribution process operators not necessarily pertaining to the same corporate group and using communications platforms – described in more detail below – that not fully integrated.

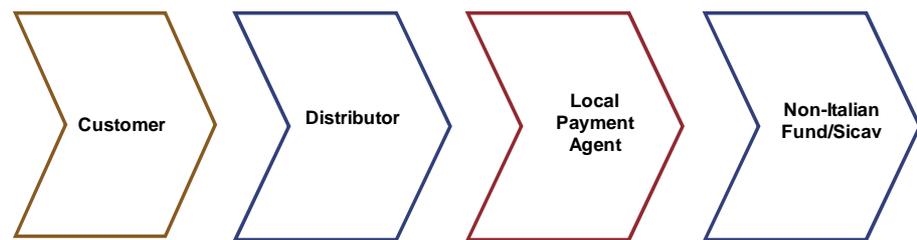
## Subscription and redemption

First we examine the direction of the information flows, with particular reference to non-Italian funds (given these products' more common use of this model), then going on to analyse the type of relations involved<sup>(39)</sup>.

As mentioned, subscription and redemption order execution processes for non-Italian UCITS units or shares are different to those for Italian funds, given the involvement of the *local payment agent* and the *investor relations agent*, which in most cases are the same. **Specifically, orders collected by the distributor in Italy are channelled to the investor relations agent**, who forwards to the non-Italian UCITS for the *evaluation* and *settlement* steps. The *local payment agent* (in the past referred to as the “correspondent bank”) arranges the monetary transfer.

An illustration is provided below of the direction of information flows for subscription and redemption orders involving non-Italian open-end funds (or SICAV shares) (*see fig. 4*).

**Fig. 4:** *Subscription and redemption order flows for non-Italian funds/SICAVs (where the investor relations agent and local payment agent are the same).*



## Unit portability

With regard to flow management performance, this represents fund unit portability<sup>(40)</sup>.

The implementation of the portability process for non-Italian UCITS units or shares is different from that of Italian funds, in that:

- a) it is more common for the two distributors (new and old) not to belong to the same group, so there may be no shared communications timeframe for acceptance;

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<sup>(39)</sup> In fact, with regard to Italian funds, the subscription and redemption order execution process follows the steps already described for the vertical integration model, except that in the few-to-many model there are wider-ranging relationships between the operators.

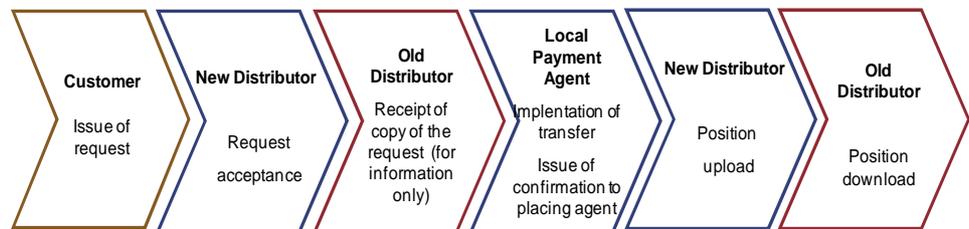
<sup>(40)</sup> The unit transfer process is not discussed here because, as noted, in the absence of a trading market it is of minor importance.

- b) an additional operator, the local payment agent, is involved and must communicate with both distributors and with the non-Italian UCITS.

Bearing in mind that communication between the operators is necessary to reconcile the investor’s units/shares position – which has to be “downloaded” from the old distributor’s account and “uploaded” to that of the new distributor – **in the few-to-many model, the old distributor’s acceptance confirmation could take from one to several weeks.**

The figure below illustrates the direction of information flows in this process (*see fig. 5*).

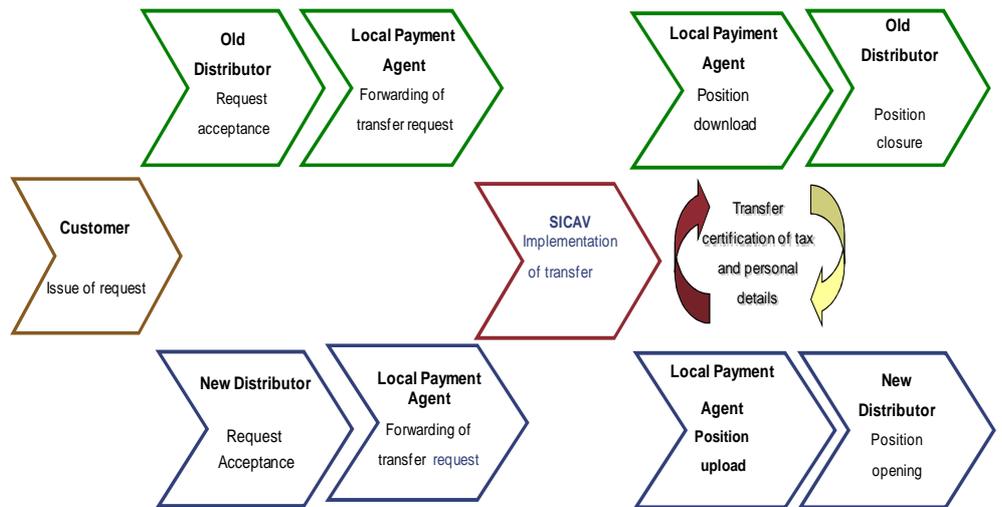
***Fig. 5: Unit portability where the distributors act through the same local payment agent***



The portability process for UCITS units or shares is **further complicated if the new and old distributors liaise with different local payment agents.**

The figure below shows the direction of information flows in this process (*see fig. 6*).

**Fig. 6: Unit portability where the distributors act through different local payment agents**



In this situation, in fact, in addition to management company (or SICAV) capture of the acceptance confirmation from the two distributors (particularly that of the former distributor), it is important that the *local payment agent* of the old distributor informs the *local payment agent* of the new distributor of tax details certification of the investor position.

**For harmonised non-Italian UCITS marketed in Italy, the *local payment agent* is also responsible for withholding tax. Thus where the local payment agent also changes, the process is more complex, involving a timeframe for completion of 1-2 months.**

With regard to keeping of the investor register (by the “registrar”), in the distribution in Italy of harmonised non-Italian UCITS considerable use is made of the "nominee" procedure. Subscription application forms for non-Italian fund units, in fact, normally offer the investor the option of appointing an investor relations agent - often coinciding with the *local payment agent* - to arrange subscription of the units in their own name and on behalf of the investor. This appointment also envisages that the *investor relations agent* is responsible for forwarding the subscription, conversion and redemption transaction data in aggregate format in their own name and on behalf of the investor.

**The fund units are recorded in the register of investors under the name of this agent, annotated to the fact that the financial instruments pertain to third parties. The investor relations agent keeps records on the individual investor positions.**

### ***3.3.2. Relations between distribution process operators and flow standardisation***

The execution of investor orders regarding **harmonised non-Italian UCITS** is based on an exchange of information flows in Italy that also involves the investor relations agents and the investors/local payment agents.

Therefore, there are several payment agents (rather than just one) for each harmonised non-Italian UCITS. This fact:

- 1 requires the asset management company to establish and maintain **multiple communications systems, or rather a multiple programming language decoding system;**
- 2 and **slows down the order execution process.**

Specifically, as observed in the description of the vertical integration model, the possible effect of the former distributor's discretionary power on the **order execution timeframe** for fund unit portability affects the speed of implementation of the end investor's decisions.

Furthermore, if the flow transmission methods are not automated there is an obvious impact in terms of increased operational risk, also with regard to preserving data integrity and the correct reconstruction of processes.

The same aspects (existence of multiple communications systems, slower execution and the persistence of manual processing) are significant for the implementation of the few-to-many model for **Italian open-end funds** as well. As noted, it is above all medium-sized management companies, characterised by consortium-style or widely-distributed ownership structures, that adopt the few-to-many model.

**To summarise, the few-to-many model is characterised by the existence of multiple information systems among the distribution process operators. Multiple platforms are normally reduced in number by decoding systems for the various languages used (i.e. flow standardisation).**

#### ***Examples***

A medium-sized management company is used in this example of information flows in a few-to-many system. This company has defined a decoding procedure for messages from the various distributors (over a hundred) and custodian banks (seven), regardless of the IT systems that they use. The procedure has allowed the management company to set up a network between distribution process operators (i.e. distributors and custodian banks) pertaining to different banking groups.

### **3.3.3. Strengths and weaknesses of the model**

The operational format in a few-to-many model implies participation of operators from multiple corporate groups. The strength of the model therefore lies in the *more open architecture* than that of the vertical integration scenario.

Despite the more open architecture, the system environment still offers only partial flow integration, because not all product distribution process operators see themselves “online” and the system is not linked to operators beyond the distribution process (i.e. to parties not classed as distributors, custodian banks or local payment agents).

The first problem – i.e. that not all distribution process operators see themselves “online” – is linked to the persistence of *manual processing* in the flow exchange steps and the processing of related flow data, which inevitably affects costs and operational risk.

The second problem – i.e. the exclusion of parties not involved in the distribution process – once again highlights the difficulties faced by investors with regard to unit portability.

This could also have some impact on competitiveness. The limited contestability implicit in this model tends to keep the various industry operators (management companies, distributors, custodian banks) mired in existing relations.

### **3.4. The operational scenario for flow standardisation**

Flow standardisation is a processing method that could be adopted regardless of the distribution model.

At baseline level, flow standardisation implies the adoption by all operators in the distribution process for open-end mutual funds (asset management companies, distributors, custodian banks) of the same **language** used for the execution of fund unit subscription and redemption orders.

In a wider standardisation scenario, language standardisation is accompanied by **procedure** standardisation.

For example, the following aspects would be important:

- standardised identification methods for all operators in the fund distribution process (e.g. the use of universally accepted codes);
- definition of the authorisation and response times to subscription and redemption orders submitted by investors and for the generation of order completion confirmation notices;

- definition of the frequency and content of reports available to customers, consistent with terms established in regulations;
- harmonisation of transaction settlement methods and timing, consistent with terms established in regulations.

***Flow  
standardisation  
for open-end fund  
transactions***

The most common distribution models for open-end mutual funds in the Italian market limit flow standardisation to the distribution process operators (which are mostly members of the provider's group in the vertical integration model, of different groups in the few-to-many model).

This is only a partial standardisation in terms of language, however, given the fragmentation of operating systems in use by the various operators involved in the fund distribution process.

If, instead, flows are standardised at system level, this could potentially create a network usable by all operators, with a standardised operating language and the possible standardisation of operating procedures, regardless of which distribution model is prevalent or whether a distributor is a member of a corporate group.

Such a network of operating language and procedures would not interfere with the structuring methods used for relations between providers and distributors. In fact, flow standardisation proves compatible with the retention of the distribution agreements that currently characterise such relations.

***Further study***

The desirability of a standardised approach at system level for order cycle management for subscription and redemption of open-end mutual funds was stressed in the report "Standardization of fund processing in Europe", published by the EFAMA in September 2008. That report indicated that the pronounced fragmentation of systems is a major source of inefficiency in the European asset management industry.

***3.4.1 Strengths and weaknesses***

System-level flow standardisation means the ability of all players in the open-end fund distribution process to communicate with one another regardless of their particular IT systems.

Overcoming the barriers between operators due to fragmentation of the communications methods and the common practice of group standardisation would make the industry more open and so raise the level of competitiveness.

***Stronger  
competitiveness***

*Persisting high  
level of  
operational risk*

Fund portability would also be easier for investors, just as access to multiple distribution channels would be easier for the intermediaries.

However, flow standardisation per se does not entail the introduction of a single dedicated platform for information flows. Indeed, in an environment of heightened standardisation of processing methods (for example, the scenario of flow standardisation plus procedure standardisation), differences in the quality of management services are destined to become even more important.

In any event, standardisation does not involve the complete elimination of operational risk, which is related in part to the residual areas of manual processing that cannot be eliminated<sup>(41)</sup>.

### ***3.5. The “single entry point” operational scenario***

This section describes a possible advanced model for the processing of open-end fund units based on system infrastructure. This scenario, defined as a “single entry point”, is similar to a two-way network system for the production of services for both user types. An initial analysis indicates that the two **user types** are the open-end mutual fund unit providers (“issuers”) and their distributors (“intermediaries”), whilst the **services** derive from an entry point between the two that facilitates standardisation and greater efficiency in their relations.

Supposing there are  $m$  issuers and  $n$  intermediaries, if there were no system infrastructure to serve as the single entry point, the number of relations that could be established to allow all intermediaries to use these services in relation to all issuers would be  $m \times n$ .

For sufficiently high values for  $m$  and  $n$ , the presence of a single entry point reduces the number of relations required and guarantees that the “link” between issuers and intermediaries would be  $m + n$ . For this solution there are at least two further prerequisites:

- harmonisation of the technology used by issuers and intermediaries;
- standardisation of communications protocols.

With particular regard to economy, cost savings would presumably increase as more and more services were centralised on the system infrastructure. But this depends on the willingness of management companies to outsource a number of their tasks and on the capacity of the party serving as single entry point to perform them.

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<sup>(41)</sup> The EFAMA-SWIFT report (March 2009) reports that in the countries involved in the survey, standardisation contributes significantly (by 83%) to automation.

The presence of a system infrastructure is independent of the institutional frame of reference, the model of governance adopted and, within certain limits, the number of parties actually providing the specific services whereby the single entry point between issuers and intermediaries operates.

### ***3.5.1 The central depository system model for dematerialisation of open-end mutual fund units.***

#### ***Elements distinguishing the management of open-end mutual fund units***

In the Italian context the provisions of the previous section already apply to all financial instruments except open-end fund units, for which a central depository serves as a single entry point. Therefore, given the provisions of the previous section, the model used for these financial instruments may also be applied to the open-end fund units, as is done, albeit somewhat differently, in France, Germany and the United States (see the tables in the Annex to Chapter 3).

The interposition of a central depository in the open-end mutual fund industry is possible under existing law, which already provides for the dematerialisation of fund units (see section 2.2.2).

Preliminary to further analysis, let us note the difference between managing the order cycle for financial instruments that do not and that do include open-end mutual fund units. In fact:

- as noted above, the relationship between asset management companies and distributors is governed by what is known as the distribution agreement. The centralised handling of open-end fund units at the depository is compatible with such agreements in a dematerialised security scenario. However, this implies that the number of relationships desired by the parties is not necessarily equal to the maximum shown in section 3.5<sup>(42)</sup>;
- the handling of open-end fund unit orders entails the involvement of the asset management company, the distributor, and other parties that vary with the jurisdiction - Italian or non-Italian - of the UCITS. With respect to Italian funds, the third party is the custodian bank, while for non-Italian funds marketed in Italy it is the local payment agent and the agent in charge of participant relations (in most cases both these functions are performed by the same party).

Other elements relevant to managing the life cycle of mutual fund unit orders include the direction of the data flow between issuer and intermediary, which will be dealt with below.

In the Italian context, for **Italian fund units** the **asset management companies** act as the issuers, while the **distributors**, act as, or can act as, the central depository participant agents<sup>(43)</sup>. The asset management

#### ***Participants in the system***

---

<sup>(42)</sup>Strictly speaking this is also true for financial instruments that do not include fund units. In this case, however, the description given in the text is a satisfactory approximation.

<sup>(43)</sup> One distributor could decide to use the services of another central depository participant and therefore act as in “indirect” user of the central depository.

company must open an account that represents the entire issue (known as the issuer account), while the distributors that participate in the central depository will have one or more accounts in which the open-end fund units owned by their clients are entered.

In this operational hypothesis, the application of the single entry point to open-end fund units implies that the central depository can offer all relevant central depository and settlement services. The **central depository management services** mainly include registering the accounting movements of the fund units resulting from the subscription and redemption of the units, plus such corporate actions as distributing income. This category also includes switch transactions, as they affect the total number of units issued, and the unit portability and transfer procedures described in section 3.2.1. As noted there, the importance of transfers is residual with respect to the other open-end fund unit transactions. Within the central depository, central depository services far outweigh settlement services, because of the great prevalence of subscriptions and redemptions within the totality of UCITS transactions. As part of the central depository services, the single entry point can provide a centralised subscription and redemption order management service, interfacing between the asset management companies and the distributors.

With reference to the fund units and as necessary, the central depository can also perform any related activities relevant to the central depository and settlement services, similar to those already carried out for financial instruments in general. Examples could include the updating of the subscription records held by the asset management companies and the calculation and settlement of fees between the asset management companies and distributors.

In general, using the data received from the asset management companies and the distributors, the central depository handles subscriptions, redemptions and portability through **simple written records**. This may involve units only or also cash.

In the specific case of subscriptions, once the management company has calculated the number of units to issue, it instructs the central depository to credit the accounts of the participating intermediaries. The depository executes the instructions from each asset management company, debiting the issuer's account. Where required, the central depository handles the transfer of funds from the participating intermediaries, or their settlement agents, to the asset management company accounts at the respective custodian banks.

The specific reference to subscription transactions highlights another difference between open-end fund units and financial instruments in general (the same is true for redemption transactions). The issuer does

*Central  
depository  
system and  
settlement  
services*

*Data flows*

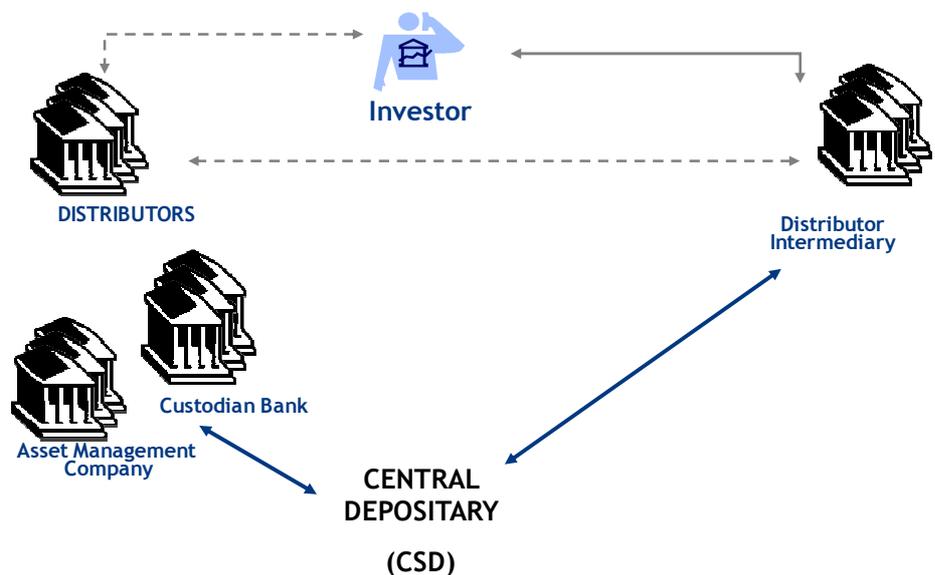
*The direction  
of the data  
flows*

not originate the subscription (or redemption) transactions but acts subject to the investor's choices. In practice, it is the distributor that notifies the asset management company of the transaction; the management company must then calculate the number of units to issue or cancel. To maximise the potential advantages of a central depository, as for financial instruments in general, **the participating intermediaries could communicate the subscription and redemption transactions directly to the central depository which, in turn, would inform the relevant asset management company.** The asset management companies would then instruct the depository to credit or debit the accounts of the intermediaries depending on whether a subscription or a redemption has been effected.

The system may appear as shown in the diagram below (*see fig. 7*).

*Fig. 7: The central depository system for open-end mutual fund units.*

*Central management and organisational strategies of the asset management companies*



As noted above, management companies often outsource their customer back office activities. In most actual cases, the party that does the outsourced work is the custodian bank, which can be thus referred to as the external service provider. In this case, the distributors transmit the subscription and redemption orders and the information necessary to manage the payments directly to this party (and not to the asset management company).

Outsourcing is fully compatible with the presence of a central depository. The management company may authorise the service provider to actually manage the issuers' account. Specifically, if the external provider is the custodian bank, it will receive information on subscription and redemption transactions and on the payments by the central depository if it received the payments from the participating intermediary.

Management of the issuer's account by the custodian bank would result in an operational mechanism whereby the custodian bank ensures the validity of the subscription and redemption transactions. As manager of the issuer's account on behalf of the asset management company, the custodian bank can also check the validity of the destination of the funds distributed through the central depository.

Regarding the custodian bank's function of holding the combined certificate for the subscribed shares in custody and updating the registers, in a central depository system the combined certificate would not be necessary.

*Combined certificate*

**Non-Italian harmonised UCITS units or shares** may be sold in Italy using links between non-Italian central depositories and the Italian central depository. This arrangement does not mean that an agent in charge of participant relations or a local payment agent cannot operate in Italy to perform tasks that cannot be performed by the central depositories. However, in this case the operational procedures may be chaotic if these agents are (only) requested to carry out secondary functions (for example, withholding tax).

*Non-Italian harmonised UCITS*

### ***3.5.2. Strengths and weaknesses***

The development of a single entry point would help reduce costs and operational risk. Obviously these effects would be increased if the central depository managed subscriptions and redemptions in addition to the portability procedures and unit transfers. This is especially true for the asset management companies that have already opted for an accessible distribution (or few-to-many) model, where the distributors

*Cutting costs and reducing operational risk*

belong to different groups. Where the vertical integration distribution model prevails, the advantage is potential.

The centralised deposit of open-end fund units in a dematerialised security scenario offers a series of specific advantages:

- resolution of the diseconomies engendered by the combined certificate and the unit management methods it involves;
- easier portability of the units;
- possible use of the units as collateral in accordance with the Euro Decree.

There would be similar benefits for the non-Italian companies or products, which could take advantage of the links between foreign and Italian central depositories.

At the same time, the introduction of a single entry point infrastructure, whoever operated it, would entail initial costs to get the system up and running. Also, the introduction of such a model, removing a series of functions from the local payment agent of the non-Italian UCITS, would raise a question of who is to serve as withholding tax substitute, a function currently performed by the infrastructure operator. However, this function does not form part of the typical activities of a central depository.

The benefits and costs related to the implementation of each of the working hypotheses considered will be further examined in the following chapter.

\* \* \*

#### **APPENDIX – EXPERIENCES WITH CENTRAL DEPOSITORY SERVICES FOR OPEN-END INVESTMENT FUNDS.**

The accounts that follow describe the main experiences with management of open-end mutual fund units by central depositories. They were examined in the course of the Working Group's hearings. The appendix treats the systems for handling fund transactions in most industrialised countries, operating as single entry points for product orders through the use of special communication channels.

These systems unite the core service of mutual fund unit order collation – via special platforms – with additional services, such as transaction settlement and reporting.

## Monte Titoli

<u>Identifying data</u>	
<b>Name</b>	Monte Titoli S.p.A.
<b>Ownership structure</b>	Monte Titoli became part of the Borsa Italiana Group (now the London Stock Exchange Group) in December 2002, following the bid made by Borsa Italiana, which resulted in its holding 98.77% of the share capital of Monte Titoli.
<b>Countries where the system operates</b>	Italy
<u>Operational data</u>	
<b>Core services</b>	<p>Monte Titoli was established in 1978 and effectively began operations in 1981 for the centralised administration of financial instruments other than government bonds. In 2000 Monte Titoli extended its range of activities to include government bonds as well. Today virtually all the financial instruments handled are in dematerialised form.</p> <p>In 2000, Monte Titoli was authorised to manage <b>the settlement services</b> of transactions on non-derivative financial instruments, leading to establishment of the Express Service on a gross basis in November 2000, and Express II in December 2003. Express II is a clearing and settlement platform that combines the settlement procedures on a net and gross basis in a single environment. As part of the settlement services, Monte Titoli manages the X-TRM matching and adjustment service, which allows the routing of the transactions to Express II or to clearing and settlement systems abroad.</p> <p>The <b>central depository system</b> is highly automated and can carry out the following:</p> <ul style="list-style-type: none"><li>• placement of new financial instrument issues;</li><li>• transfer of financial instruments in free-of-payment mode, both on domestic and cross-border, with high security standards and immediate information on the outcome of the transactions;</li><li>• management of company transactions on centralised financial instruments, both Italian and non-Italian, by the settlement in central bank or commercial bank money.</li><li>• tax assistance in order to benefit from any tax benefits from dual taxation treaties with other countries, on the</li></ul>

	income deriving from the centralised non-Italian financial instruments.
<b>Additional services</b>	<p>Monte Titoli also provides value added services, including:</p> <ul style="list-style-type: none"> <li>• <b>FIS</b> – Management of Standardised Information Flows, which provides for the communication of the shareholders’ names by brokers to the issuer companies, as provided by law, for shareholders’ meetings, dividend payments and capital transactions (the service guarantees the matching and control of the data from the intermediaries before forwarding to the issuers);</li> <li>• <b>CPA</b> – Communications about Participants in General Meetings, which allows the intermediaries to notify the issuers of the names of the shareholders that intend to take part in the meetings, in lieu of the paper-based notification;</li> <li>• <b>Info MT</b>, which gives indirect participants in the central depository system information on corporate actions on the financial instruments within the system, in addition to other information provided by Monte Titoli.</li> </ul>
<b>Transactions on UCITS</b>	To date, Monte Titoli manages the central depository service, the settlement service (Express II) and related additional services (matching and adjustment), including those involving listed mutual funds (closed-end funds and Exchange Traded Funds).
<b>Platform used and fees charged</b>	<p>The Monte Titoli services can be accessed through various communication channels: RNI (<i>Rete Nazionale Interbancaria</i> [National Interbank Network], SWIFT and MT-X – Monte Titoli Internet Communication System.</p> <p>The <b>services</b> are subject to a flat rate fee, except for:</p> <ul style="list-style-type: none"> <li>• the <b>central depository</b> service, for which intermediaries are charged a graduated fee, regressive with the size of their account;</li> <li>• the line 1 <b>FIS/CPA</b> services, which carry a fee structured according to brackets of numbers of names. If the maximum number is exceeded, a fee for the excess is charged.</li> </ul>

## Euroclear

### Identifying data

<b>Name</b>	<i>Euroclear SA/NV</i>
<b>Ownership structure</b>	<p>87% of the share capital of Euroclear plc (parent company) is held by 216 shareholders who also use the system, as they are Euroclear customers. The remaining 13% is held by Sicovam Holding SA (established following Euroclear's purchase of Sicovam SA or the French National Central Depository, renamed Euroclear France), also mainly held by companies belonging to the Euroclear Group.</p> <p>Euroclear SA/NV, whose capital is fully held by Euroclear plc, in turn 100% controlled by Euroclear Bank (ICSD – International Central Security Depository with registered office in Brussels) and the following national CSDs: Euroclear France SA (French CSD with registered office in Paris), Euroclear UK &amp; Ireland (CSD for Great Britain and Ireland with registered office in London), Euroclear Nederland (Dutch CSD with registered office in Amsterdam), Euroclear Belgium (Belgian CSD with registered office in Brussels), Euroclear Finland (Finnish CSD with registered office in Helsinki), Euroclear Sweden (Swedish CSD with registered office in Stockholm). In addition Euroclear SA/NV controls EMXCo (platform for the automatic transmission of orders for British investment funds) and Xtrakter Ltd. (a company that owns TRAX, a trade matching system).</p> <p>Euroclear also has seven representative offices abroad (Frankfurt, Saõ Paulo, New York, Hong Kong, Tokyo, Singapore, Beijing).</p>
<b>Countries where the system operates</b>	<p>Euroclear manages central depository systems through the above-mentioned offices in addition to domestic and cross-border settlement of transactions in securities, bonds, shares and investment funds. It was established as the central depository for Eurobond securities and subsequently extended its business to include a wide range of products and services, now representing a single access point for post-trading services with respect to the various financial instruments dealt with in more than 30 different countries.</p>

### Operational data

<b>Core services</b>	<p>The Euroclear group provides a full range of instruments and services, in support of post-trading activities. The main activity is custody and management of shares, bonds and mutual investment funds units.</p>
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	<p>Euroclear Bank acts as the International CSD and offers settlement and asset servicing for international bonds, money-market instruments, shares and funds. It also performs some activities indispensable to settlement, as it is authorized to engage in such banking/financial activities as cash and securities lending.</p> <p>Since the other group companies are the domestic CSDs in their respective countries, they carry out custodian, regulatory and asset servicing activities at local level.</p>
<p><b>Transactions on UCITS</b></p>	<p>Euroclear Bank manages FundSettle with specific regard to open-end mutual fund subscription and redemption transactions, a platform for the automatic processing of the fund transactions that covers about 20 national markets. The main ones are the cross-border markets of Luxembourg and Ireland, plus other local and offshore markets such as Austria, Belgium, France, Germany, Italy, Sweden, Switzerland/Liechtenstein, United Kingdom, Norway, Guernsey, Jersey, Isle of Man, Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Labuan, Mauritius, and the Dutch Antilles. The platform allows for the settlement of open-end mutual funds, money market funds and hedge funds.</p> <p>FundSettle is to facilitate transactions between fund distributors and the providers, as it can operate with both transfer agent models and CSD distribution models*. Specifically:</p> <ul style="list-style-type: none"> <li>• as part of the TA type distribution models (like the Luxembourg Sicavs), FundSettle acts between the institutional customer and the transfer agent who holds the accounts register for the fund units;</li> <li>• when dealing with CSD type models (like the French funds), FundSettle is used between the institutional customer and the local CSD where the orders are settled.</li> </ul> <p>FundSettle contributes to the automation of the markets with both models, facilitating the transmission of subscription, redemption and switch orders and their settlement through standard messages. At the same time, payment flows between the distributor and the provider in different currencies are simplified. The distributor can centralise cash</p>

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\* The transfer agent model provides for a transfer agent to act between the fund provider companies and the various parties that distribute the fund units. The distributors have direct contact with the customers, including the end-investors.

The CSD model provides for a central securities depository which holds the fund units on a centralised management basis, and therefore registers the movements and manages settlements, thus intervening with the participants in the clearing service. These participants in turn have a direct relationship with the end-investors or an indirect relationship through one or more agents. In addition this model is not incompatible with the transfer agent figure who can be authorised to carry out certain functions, especially the keeping of the fund register.

	<p>flows in a single FundSettle account.</p> <p>Euroclear also processes the fund unit orders through the FundSettle platform (order routing).</p> <p>In this context, the fund units are <b>dematerialised</b> on an <b>optional</b> basis.</p>
<b>Additional services</b>	<p>The value added services offered by the system - known as <b>asset servicing</b> as they regard the life cycle of the assets – are custody of financial instruments, the opening of new accounts by the Transfer Agent, distribution of dividends, notification of corporate actions, access to a database with operating information on about 40,000 funds, real-time reports on the status of the orders, and a statement of account of the units held in portfolio, facilitating reconciliation. An individual customer service is also provided.</p>
<b>Platform used and fees charged</b>	<p><b>FundSettle.</b> The users of this platform can choose a specific communication channel to transmit orders and receive execution and other reports (for example SWIFT, Bloomberg, FTP, file uploads, browsers). Other channels can be used to create a valid back-up system and also operate on a contingency system.</p> <p>The membership fee is calculated partly as a percentage of the amount of the units held with FundSettle and partly as a percentage of the total amount of the user's subscription and redemption orders. The fees are calculated on a monthly basis and the invoice is sent at the beginning of the following month. A new pricing system was launched recently that transferred part of the costs of using the platform from the distributor to the fund provider.</p>

### **Clearstream**

<u><b>Identifying data</b></u>	
<b>Name</b>	<i>Clearstream International Luxembourg</i>
<b>Ownership structure</b>	<p>The share capital of Clearstream International Luxembourg is entirely held by Deutsche Borse AG Frankfurt.</p> <p>The holding company's Group includes including Clearstream Banking Luxembourg and Clearstream Banking Frankfurt.</p>
<b>Countries where the</b>	Clearstream is a global system operating in Europe, America, Asia and Africa.

<b>system operates</b>	Some of the European countries that use the system are: Austria, Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Spain, Switzerland and the United Kingdom.
<b><i>Operational data</i></b>	
<b>Core services</b>	<p><b>Clearstream offers central depository and settlement systems in delivery versus payment (DVP) and multi-currency form</b> for transactions in financial instruments.</p> <p>As an international CSD, Clearstream International Luxembourg offers custodian and settlement services of international financial instruments plus other added value services.</p> <p>In its role as a domestic CSD, it offers custodian and settlement services in Germany and Luxembourg.</p>
<b>Additional services</b>	<p>The set of added value services offered by the system – known as <b><i>asset servicing</i></b> as they regard the life cycle of the assets – involve corporate actions, the advance of funds and the possible use of the liquidity deriving from intraday settlements.</p> <p>Clearstream Banking Luxembourg makes the Vestima platform available to deal specifically with open-end mutual funds (see below). As part of its centralised management system, Clearstream holds an account registered in each fund’s register. The account is an <b><i>omnibus account</i></b> and records the positions in funds held in its own name but on behalf of its members. The Vestima platform makes reports on the names of the individual agent—distributors available for the provider, in accordance with a previously agreed schedule.</p>
<b>Platform used</b>	<p>Using the Vestima platform, Clearstream Banking Luxembourg can interface with distribution models that are configured on the basis of the transfer agent types and the CSD types, with special regard to the <b>open-end mutual fund</b> subscription and redemption transactions. This platform can carry out order routing. Specifically, once the orders have been entered into the system and confirmed, Vestima can automatically generate the payment instructions.</p> <p>In this context, the fund units are <b>dematerialised</b> on an <b>optional</b> basis.</p>
<b>Type of funds handled</b>	Exchange-traded funds and any kinds of open-end type mutual investment funds.

## NSCC

<u>Identifying data</u>	
<b>Name</b>	<i>National Securities Clearing Corporation</i>
<b>Ownership structure</b>	<p>The National Securities Clearing Corporation is entirely held by DTCC (Depository Trust &amp; Clearing Corporation). The Depository Trust &amp; Clearing Corporation in turn has a consortium structure, owned by its users (mainly banks, institutional investors, insurance companies, asset management companies, etc. that offer financial services on a world-wide scale).</p> <p>Specifically, the NSCC is the branch office of the DTCC principally involved in the mutual investment fund and exchange traded fund sectors.</p>
<b>Countries where the system operates</b>	<p>The system operates in the United States as a de facto monopoly. It offers the possibility of settling reciprocal obligations with other (non-U.S.) central depository platforms that handle investment fund units.</p>
<u>Operational data</u>	
<b>Core services</b>	<p>The DTCC group offers <b>central depository, payment, guarantee and settlement</b> services for transactions in financial instruments.</p> <p>The integrated service offered by NSCC allows all operations relevant to <b>mutual fund</b> transactions to be carried out in a standardised and automated manner. The main services are clearing and payment and settlement (on a variety of settlement cycles), carried out by the Fund/SERV module, the recording of positions in the customers' accounts, and notification to the party in charge of the registrar functions, performed by the ACATS module.</p> <p><b>Cash</b> settlement is via the central bank, on the accounts of banks and SCC itself.</p>
<b>Additional services</b>	<p>The value added services provided by the system are direct receipt of orders by the Fund/SERV platform and, if necessary, corrections and cancellations, communications between the various parties involved, settlement of fees, and updated data for the valuation of fund units (i.e. NAV).</p> <p>These services, known collectively as the <b>Mutual Fund Profile Service</b>, are based on management of the three databases (Security Issue, Participant and Distribution) that concern the funds and the participants in the distribution</p>

	<p>process, and are continuously updated.</p> <p>Specifically, NSCC manages the circulation of the information regarding the <b>identity of the end-investors</b> with the collaboration of the distributors. If the distributors take on the responsibility of administrating the relevant information, the NSCC platform can constantly align the broker/dealer results and the transfer agent results, so the transfer agents have a record of the end-investors.</p> <p>Fees are settled on a flexible basis (daily, weekly, monthly settlements), but this is automated and standardised.</p>
<p><b>Platform used and payment fees charged</b></p>	<p><b>Fund/SERV.</b> This is a platform with networking capabilities. It manages the stages starting from reception of the orders to the transmission of the reports. However, given the high modularity of what is available, the service level is chosen by the participants of the platform itself.</p> <p>The participants can connect to Fund/SERV through the internet (DTCC WebDirect) or by appropriate platforms (such as Fund/SPEEDSM, NSCC's XML interface).</p> <p>The ownership structure of DTCC (namely, the fact that is a consortium) means that payment for the services, including through branches, is on the basis of the <b>base cost</b> principle, i.e. considering the costs incurred for the actual provision of the services, with no mark-up.</p>
<p><b>Type of funds handled</b></p>	<p>Exchange-traded funds and all mutual investment funds traded in the United States.</p>

## CHAPTER 4 – Cost-benefit analysis

### 4.1. Introduction

#### *Alternative scenarios*

This chapter analyses the costs and benefits of the methods now used to manage customer instructions and assesses how they could be affected by alternative scenarios, i.e.:

- the system-level standardisation of the interconnection procedures;
- the centralised management of the open-end fund units in a dematerialised security scenario, with a central depository company that intervenes between distributors and asset management companies in the management of the units and the reception and transmission of subscription and redemption orders. This scheme entails not just the standardisation of information flows but an infrastructure for full integration of the information systems.

#### *Interviews with market operators*

In this analysis, information was drawn from a series of interviews conducted with a representative sample of the various types of intermediaries – distributors, asset management companies, custodian banks, payment agents for the non-Italian harmonised UCITS, etc. (see *Annex 3 – List of parties interviewed for the cost-benefit analysis*); the interviews were carried out in accordance with a pre-established plan to procure qualitative information and make more in-depth analyses on specific aspects such as:

- the manual phases of the subscription and redemption procedures (percentage of manual operations remaining in the transactions carried out, staff assigned to manual tasks with respect to total staff employed in the customer back office function, etc.);
- the procedures and costs involved in holding the units, with special reference to the issue and custody of registered and bearer certificates;
- the “portability of the units” from one distributor to another at customer’s request<sup>(44)</sup>. Impediments to unit transfer (for instance,

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<sup>(44)</sup> As noted in Chapter 2, in order to subscribe to fund units it is not necessary to open a security dossier with the distributor; the customer’s units remain in “custody” with the custodian bank, which enters them in a combined certificate or, if the customer wishes, issues “printed” certificates, generally debiting the costs to the customer. However “proof” of the unit positions can be found in the distributor’s information systems. The distributor provides post-sales assistance, and also provides information on the composition and value of the overall portfolio on a regular basis.

Portability occurs when the customer changes distributor and wants to transfer the position to the new intermediary. The units still stay on deposit with the fund custodian bank and the customer still has the option of going directly to the asset management company. However, it is evident that the customer needs to transfer the position to the new agent, in order to have an overview of the entire financial portfolio and to use the services offered by the new distributor (execution of new subscriptions or redemptions).

in order to “follow” a salesman whom the customer trust and who moves to a distribution network that does not have an agreement with the asset management company) may consist in costs for the customer who wants to move to another distributor, who may have to bear exit fees or the costs of unfavourable market situations (as when the fund is making a loss and has accumulated significant tax savings).

Below we describe the framework of the analysis and set out the results.

## 4.2. Framework of analysis

### *Stakeholders*

The persons involved in the procedures examined and that have a stake in future developments are:

- supervised intermediaries (asset management companies, custodian banks, asset management companies, local payment agents for the non-Italian UCITS, sales networks);
- providers of administrative and accounting services to support the management activities;
- customers;
- Supervisory Authorities;
- the economic system as a whole.

### *The factors considered*

The possible costs for the execution of customer request procedures and administration of the fund units were classified according to effects: quantitative (e.g. costs directly related to the procedures) or qualitative effects; short-term or long-term; individual (on the single agents) or systemic.

More specifically, the classification was as follows:

- a) **recurring costs** of the fund unit subscription and redemption request administration procedures. This includes staff costs – the networks, the asset management companies, the outsourced administrative entities, and the custodian banks – that perform matching, input and uploading of data into the information systems, filing, issuing of the units (registered and bearer) and “ordinary” maintenance expenses of the information systems and procedures. If, for instance, a central depository were introduced for the units, the costs for access and operation of these systems would be considered (fees, transaction costs, etc.);

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As for the relationship between distributor and the asset management company, the transfer assumes that the latter has a distribution agreement with the new distributor and that there are interconnections in order to be able to update the customer position.

- b) **“one-off” costs** for investment in installation and revision of the information and interconnection systems and procedures and updates to the internal instruction manuals and contracts. The opportunity costs of investment in information, interconnection and procedural systems were also considered, i.e. the losses due to strategy changes and cost-cutting measures (for example asset management company mergers, outsourcing or return in-house of administrative and accounting departments back, change of outsourcers, etc.);
- c) **qualitative effects**. Special attention was paid to the following issues:
- the **“portability” of the units**, i.e. the time-frames and charges related to the transfer of fund positions from one distributor to another;
  - the **remaining manual stages in processing**, with special regard to the operating and legal risks related to systems that are not fully integrated;
  - the **degree of system openness**, with special reference to the costs/benefits for the financial system produced by a distribution model based on “silos”, i.e. integrated structures between managers and distributors belonging to the same group, which, while conducive to “internal” efficiency, have tended to stifle competition both in distribution and in asset management;
  - the **degree of customisation** of the services offered, considering that customised service availability has been developed (for example capital accumulation plans or scheduled switches) which was considered important in terms of capacity to instil and maintain relationships with the investors.

*Comparative scale*

In order to estimate the impact of alternative scenarios as described above, a comparative scale expressed in incremental terms with respect to the existing situation (0 option) was prepared (and submitted to the interviewees).

COMPARATIVE SCALE WITH RESPECT TO THE 0 OPTION						
+ 3	+ 2	+ 1	0	- 1	- 2	- 3
High benefits with respect to the 0 option	Medium benefits with respect to the 0 option	Low benefits with respect to the 0 option	No significant change with respect to the 0 option	Low costs with respect to the 0 option	Medium costs with respect to the 0 option	High costs with respect to the 0 option

The scale is strictly ordinal and does not permit comparisons of a cardinal nature to be made between the various scenarios. Costs and benefits are converse variables: a reduction of a cost is a benefit and vice versa. In addition it is important to distinguish between the short- and long-term effects of process changes.

### 4.3 Evaluation of costs and benefits

#### 4.3.1 *Costs under the current system*

#### *Variables that affect back office costs*

There are a variety of organisational solutions and cost profiles in this area. The size of the customer and unit administration structures, in terms of human and technical resources, hence costs, depends on a series of variables such as:

- the frequency with which the units and subscription and redemption transactions are calculated;
- the distribution structure (captive or accessible to networks outside the asset management company's group; the number and type of distributors; whether the website is interactive or just for information purposes, etc.);
- the degree of automation of the procedures and information systems;
- use of outsourcing. Certain medium-sized asset management companies – owned by banking consortiums or by a large number of shareholders, with a large number of distributors, its own brand separate from the brand of the equity holders or the distributors – mainly carry out the administration and NAV calculations in-house. However, it has become increasingly common in the industry to outsource these tasks to specialised firms (distributors, service companies, custodian banks) that offer these services to a number of different intermediaries; the decision to outsource is often made by smaller-sized agents (who prefer to use specialised service companies for all administrative activities, including the calculation of fund units) or by larger asset management companies that belong to banking groups (which are the main distribution channel, carrying out both custodian bank services, back office services and calculation of fund units). The outsourcing of administrative activities, subject to continuing oversight, enables the asset management companies to make their cost structures less rigid<sup>(45)</sup>.

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<sup>(45)</sup> The outsourcing may differ in nature: in the case of an asset management company that is not part of a group, it involves the actual assignment of company services/procedures to third parties, while in

**This variety means – as emerged in the interviews with individual intermediaries and confirmed by supervisory data – that the adoption of alternative scenarios may have different consequences at the level of the single firm.**

This variety means that quantitative evaluations cannot be made, as the data are not comparable, but the data do allow for a more qualitative evaluation, helping to gauge the cost impact of the various scenarios and focusing on specific aspects such as the management of printed certificates and unit portability.

***Recurring and one-off costs***

With reference to **recurring costs** and **one-off costs**, the information drawn from the operators confirms the presence of significant economies of scale, which explains the tendency to centralise these tasks with specialised firms and the widespread use of outsourcing. The expenses involving “customer administration” account for about one third of total back office costs. The “recurring” expenses consist chiefly in staff costs, which outweigh IT maintenance and procedural outlays. The latter do not seem to have a significant weight (even when they are extraordinary) in the case of the asset management companies that have outsourced their customer back office departments to a company specially designated for this task (often belonging to the same group).

With special regard to the one-off costs, the implicit costs resulting from the existence of multiple standards at system level in the interconnection procedures must be considered. Sometimes different standards have to be managed and standardised even within the same group, due to mergers of intermediaries, each with its own network and connection systems.

Any time a distributor makes a new agreement to distribute the fund units of an asset management company, it may incur costs for to communication with the provider (or with its administrative outsourced company) for sending the subscription/redemption flows and receiving the return flows needed to update the customer’s position. Not all the investments made to connect with an asset management company can be reused if the distributor decides to change and/or link up with a different manager.

***Manual operations***

The variety of procedures that connect distributors, asset management companies and administrative outsourcers will result in higher variability in the time required to execute customer subscription/redemption requests. Clearly it takes longer if there is no IT interconnection and the distributor sends the customer requests to the asset management company by other means (for example, by fax).

There is a high degree of automation in the unit subscription and redemption management procedures and in the interconnection

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the case of intermediaries that belong to groups, it can sometimes reflect the rationalisation of corporate functions performed by individual group components.

between the systems and different parties involved. Some other processing stages, however, are characterised by a large amount of **manual** work:

- management of the printed certificates requested by the customers. In most cases, the printed certificates are issued to provide guarantees on personal loans. The cost of managing printed certificates is usually included in the fees for the custodian bank services, and thus defrayed out of fund assets. This cost (quite small) is supplemented by a fixed charge (varying from company to company) to the customer who requests the printed certificates;
- the direct input of subscription and redemption data by the asset management company or the associated outsourcer (in place of the network that generally inputs the data during the procedures). This happens mainly in the management of the relations with institutional customers where there are unrelated distributors (with small transaction volumes that do not justify interconnection costs). In any case, the asset management company always maintains a supervisory role to directly manage customer redemption orders, and also subscription requests in case of direct sales by asset management companies;
- blocking flows loaded by the distributors, which may occasionally be incomplete or contain errors;
- the reconciliation and matching of the documentation.

Although the manual operations account for a low percentage of all the operations carried out as part of the customer back office work, about half of all the back office resources are involved in this work.

### *The portability of the units*

A special study was made of the **portability of the units**. The interviewees reported that the number of requests for transfers between distributors is negligible with respect to total customer relationships. Generally, the reason is the transfer of a financial salesman and his/her customers from one network to another. However, it can happen that when an investor informs the intermediary of the intention to transfer the investment, no action is taking for portability of the units.

For Italian funds the time needed to record the transfer of the fund position with the asset management company is not long (from 1 or 2 days to about a week). Some interviewees noted that the recognition and speed of the transfer also depends on the behaviour of the financial salesmen.

For non-Italian funds, with distributors that use different local payment agents, unit transfer times may be lengthened if the “new” intermediary does not use one of the same local payment agents as the “old” distributor. The use of different local payment agents considerably lengthens the process (sometimes up to two months), owing among

other things to fiscal problems (need for the intermediary taking the customer on board to calculate the tax position).

When the intermediary does not have a distribution agreement, the transfer of the units is not effected. In this case, the customer may only deal directly with the asset management company in order to have information on the investment situation and ask for redemption, switches or new subscriptions, unless the asset management company and the “new” intermediary sign a distribution agreement.

*System  
openness level*

With regard to the **openness of the system**, since every distributor that wishes to distribute an asset management company's products incurs costs for to "link up" with it, it was found that the existence of multiple standards in the industry can engender stickiness in relations between distributors and asset management companies, and between the latter and administrative outsourcers (where, on the contrary, it is the outsourcer that establishes the interlink standard), limiting the benefits of competition.

*The level of  
service  
customisation*

With regard to the **level of customisation of services**, in recent years products have been developed with special yield formulas and fee structures, in addition to subscription and redemption procedures that use distinctive accumulation and yield consolidation mechanisms (e.g. PAC, which replicates life-cycle strategies). The achievement of a high level of service customisation in the procedures, the interconnection mechanisms and the information transmitted between the participants in the distribution process was made easier by the current level of procedural flexibility.

#### **4.3.2. System standardisation**

In accordance with the above, we have considered the hypothesis of adoption of standard type interconnecting language, procedures and systems (please refer to the illustration in section 3.4). Notice that system standardisation does not imply the use of the same IT system.

The positive and negative effects of standardisation of the system with respect to the current situation were checked in reference to the factors specified in section 4.2 for cost-benefit analysis.

The results are illustrated below.

*Recurring and  
one-off costs*

From the point of view of **recurring costs** and **one-off costs**, there is likely to be a shortening of processing times and greater completeness and uniformity of the data, although there will be a need for infrastructural adjustments between different systems whenever a new connection has to be installed in order to expand the distribution network or extend the range of products. A relevant example here is the different “service centres” in the banking and financial industry, which

while not setting system standards nevertheless represent flow aggregation and standardisation points that benefit their users.

It is difficult to estimate investment in IT due to the diversification of the current “starting” situations of each intermediary that would be affected by the change. Specifically, for the intermediaries that already have a standardised situation, there is the risk that the change in standards could make investments in recent years to increase the efficiency of the subscription and redemption procedures obsolete.

However, we must distinguish between short- and long-term consequences. In fact, the interviews have shown that in the short run the change of procedures would impose equipment costs and charges in connection with the lack of return on previous investments, but in the longer term these costs could be recouped thanks to the positive effects at system level in terms of lower operational risk, portability of the units and greater openness, and the lower replacement and maintenance costs for the information and administrative systems.

***Manual operations and operational risks***

In general, it is expected that, since standardisation of the language and/or procedures does not mean that the IT systems used by all the system operators would have to be the same and since it does not involve activities that are inherently manual, it would have a limited impact on the remaining manual aspects phases of operations and hence on the level of risk of error.

In any case, sharing flow transmission times for subscription and redemption orders, execution and settlement time-frames, and transfer methods between subscribers, distributors and custodian banks would increase the system’s speed and certainty. The impact in terms of **reduction of operating risk** is clear.

***Unit portability***

**Unit portability** between one intermediary and another could be facilitated from the point of view of the time to execution insofar as procedural standardisation relates to the execution times of the orders themselves, permitting resolution of the technical stickiness that now slow down the transfer of the positions from one distributor to another.

***In-depth analyses***

Regarding portability, the Italian Banking Association (ABI) has developed a standardised transfer service for financial instruments, including UCITS units (known as the TDT service). The service, scheduled to begin in June 2010, will:

- a) allow a customer who switches banks to have the new bank automatically transfer his financial instruments from the dossier with the old bank;
- b) allow the management of requests to change distributor bank for Italian and non-Italian non-dematerialised UCITS held by an investor.

*System  
openness*

With regard to the system's **degree of openness**, it was noted that removal of the stickiness in relations between networks and providers stemming from multiple languages and procedures could foster more open systems.

*The level of  
service  
customisation*

The standardisation should certainly be combined with intermediaries' capacity for innovation in the funds on offer. Therefore, in a scenario where procedures are standardised, a level of flexibility should be guaranteed in any case to allow implementation of a different range of options with respect to the product on offer.

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To summarise the foregoing findings, the table below shows the evaluation of the system standardisation scenario, as found in the interviews carried out and using the evaluation scale set out in section 4.2.

<b>Evaluation factors</b>	<b>Score</b>
Recurring costs	-1
One-off costs	-1
Reduction of the manual procedures and reduction of operational risks	+2
Portability of units	+2
System openness	+1
Level of service customisation	0

#### ***4.3.3. The single entry point model***

The hypothesis here, illustrated in section 3.5, is not only the standardisation of the type of interconnection with the central manager interposed between distributors and the asset management company, but also a single IT system, shared with the central depository, insofar as this would constitute a system infrastructure.

This scenario too was evaluated according to the same factors used to evaluate the previous scenarios (current situation and system standardisation); they are described in section 4.2.

*Recurring and  
one-off costs*

As regards the **one-off costs**, they would be incurred only in order to join the system: the costs of establishing new sales relationships would be eliminated, as all participants in the distribution process would use the same IT system.

In order to completely eliminate the one-off costs, the IT systems for the single entry points must be flexible enough to permit prompt

implementation of changes to the product features relevant to the subscription and redemption procedures (e.g. introduction of a new class of units, amalgamation of funds, etc...).

From the point of view of **recurring costs**, the items to consider are the costs of the services that would be provided by the central depository and the extent to which these simply replace the costs currently incurred. In this context, it is important that the single entry point not translate simply into a proliferation of participants in the distribution process. Rather, the single entry point should be associated with order management, unit settlement and information services to the asset management companies and the distributors (for example, updated data on the identity of the investors, and on the amounts subscribed through each distributor).

In that sense, since the single entry point can store the aforesaid information and serve as a “facilitator” in the interchange of data, it would lower operating and administrative costs for the system users.

Certainly the fact that a series of functions currently performed by various companies (custodian banks, companies/intermediaries that provide fund administration services) would all be performed by the single entry point means there would have to be a reconversion of these activities and the resources (human and infrastructural) now assigned to with them.

The single entry point would be added to the fund distribution process chain that is now characterised by vertical integration or few-to-many models. Thus the introduction of centralised management must be evaluated differently according to the point of departure.

With respect to the recurring costs, subscribers who do not already have a security deposit with the distributor may incur costs for the administration and custody of the fund units entered into the central depository system with the intermediary (stamp duties or any security deposit fees).

*Manual operations and operational risks*

With reference to the impact in terms of **operational risks**, since the institution of a central depository system would be part of the standardisation of procedures (order execution and settlement times, transfer modes, etc.) the considerations made in the previous section apply.

However, in a scenario where a single entry point would intervene between asset management companies and distributors, the reduction in operational risks would be maximised by virtue of the great simplification and reduction of data flows between the asset management companies and distributors and the significant limitation of **manual** operations and the staff assigned to them (and a consequent reduction in the largest recurrent cost component).

In a renovated environment marked by such a reduction in operational risk, it would be possible to the development and innovation of the core management activities could be favoured over the back office activities.

*Unit portability*

As regards **unit portability**, the considerations on the system standardisation scenario apply, since the benefits of this process derive mainly from sharing order execution times. If the fund units are centralised in a single infrastructure, transfer times would be faster (comparable to those for the financial instruments dthat are already held on a centralised basis: listed shares, ETF units, etc...).

*System openness*

Specifically, the linking of the various information systems in a single structure could give rise to a **more competitive** system in which:

- each asset management company would have a single connection point to enhance the possibility of distribution of its products;
- each distributor, in turn, could considerably increase the range of products offered, with encouragement for accessible type distribution structures and advisory services;
- any asset management company or distributor belonging to the same central structure could reach an agreement without having to prepare an ad hoc connection.

From this point of view, the innovative capacity of a single entry point system, which could also count on the updated regulatory framework of MiFID, lies in its encouragement to intermediaries to move towards the core management activities, as regards product providers, and well-developed advisory services, as regards the distributors.

A system infrastructure could also permit the investors to directly access the instruction and operational functions that relate to the fund investment, which could encourage investment in asset management products.

*The level of service customisation*

Lastly, with reference to the level of service customisation, the interviews revealed how important it is for the IT system of the system infrastructure to have a degree of flexibility such as to prevent the limitation of product innovation and allow prompt implementation of changes in product features relevant to the subscription procedures (for example those concerning pricing).

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To summarise the foregoing findings, the table below shows the evaluation of the single entry point scenario, as found in the interviews carried out and using the evaluation scale set out in section 4.2.

Evaluation factors	Score
--------------------	-------

Recurring costs	-1
One-off costs	-3
Reduction of the manual procedures and reduction of operational risks	+2
Portability of the units	+2
System openness	+3
Level of service customisation	0

## CHAPTER 5 – Conclusions and operational guidelines

### 5.1. The findings

*The market context*

The working group established by CONSOB, in collaboration with the Bank of Italy, sought to set out operational guidelines to overcome the difficulties surrounding Italian asset management, which has been marked by negative fund-raising for a number of years, aggravated by recent events in the financial markets.

The recent short-term consolidation of the financial results of the sales networks was made possible by a large-scale transfer of liquidity from investment funds, mainly bond funds, to “substitute” products (such as bonds and insurance policies) that can raise liquidity directly from the savers at relatively low cost.

This critical situation highlighted the urgent need to evaluate any structural weaknesses in the asset management industry and develop solutions in various areas (governance structures, tax situation, distribution models, harmonisation of the transparency rules between “competing” products).

The working group established by the Bank of Italy on the asset management crisis took that direction, and in its final report in July 2008, it identified a number of actions to take with the relative calendar<sup>(46)</sup>.

Among the asset management profiles, reference has already been made to the low degree of strategic independence of the asset management companies from their parent groups in the CONSOB *Quaderno di Finanza* no. 61/2008, which said:

- over the years in Italy, the distribution model that arose was one of vertical integration between the product “provider” and group distributors (mainly captive banking networks);
- the pricing of Italian open-end mutual funds was notably influenced by dependence on the group networks. Distributor payments ended up being the main cost element of the fund-product<sup>(47)</sup>.

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<sup>(46)</sup> Some of the lines of action identified were aimed at evaluating the independence of the asset management companies with respect to their parent groups. From that point of view, the Bank of Italy recently put a set of rules for banking groups, complementing existing provisions on internal controls and corporate governance, up for consultation. The aim is to capitalize on of the independence of the management companies and safeguard their ability to act in the exclusive interest of the investors, by specifying the mode of exercise of the parent company’s management and control powers.

<sup>(47)</sup> As noted in Chapter 3, the data shows that about 78% of the fees paid by asset management companies to distribute open-end funds established and managed by themselves, which can be considered as proxies of the relative importance of distributors, went to intra-group companies.

*The regulatory context: Mifid*

In the current market context, it is to be hoped that asset management can regain its full importance in distributors' marketing strategies.

The opportunity is further encouraged by the renewed vigour with which the **MiFID** confirmed that the relationship with the intermediaries must be founded upon the investor's interest<sup>(48)</sup>.

*The findings: the important aspects of the fund processing*

The working group considered the market context and the regulatory framework in complex and demanding activities carried out over the year. The main theme of the work was the search for conditions of greater efficiency and competitiveness in the Italian asset management industry.

The analysis revealed certain important aspects that characterise open-end mutual fund unit fund processing. The weakest element is the presence of **multiple systems, procedures and languages** in the distribution of fund units.

**This fragmentation ultimately acts as an obstacle to the initiation of new sales relationships** between the companies involved in fund unit distribution.

This also gives rise to certain failings in the **way** the mutual fund unit **orders are managed**: for example, consider the slowness of execution of customer orders for unit portability, or the operational risks arise when certain stages of processing involve significant manual operations.

*The creation of a more competitive system*

This gives rise to the need to provide incentives to the industry to reduce the fragmentation of the operating mechanisms in order to establish a more competitive market for management and distribution services. In that context, the asset management company should focus on modernizing management policies to pursue the investors' interests, improve the quality of the fund product, in order among other things to make mutual funds more competitive with respect to substitute products.

## **5.2. The evolution of operational models**

The conclusions that the working group reached are important in the definition of operational solutions that could help overcome the difficulties of the asset management industry and help it to grow, along the lines traced out in the MiFID.

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<sup>(48)</sup> The cardinal principles that the regulations have established should be read with this understanding: best execution, inducements, information obligations, rules of conduct and contracts.

*Standardisation of the system*

It was broadly agreed that it was necessary to adopt a **system standard** to support the industry in the way it manages its open-end mutual fund unit orders.

The standardisation of the language and procedures would ensure **certain and prompt execution of the processes** for subscription and redemption orders, including through the joint definition of deadlines. This would definitely be an essential step towards overcoming the fragmentation of the mutual fund system.

In an evolving environment, the further step of creating a system infrastructure, accompanied by **central depository management of the open-end fund units in a dematerialised security scenario would given the industry more efficient operational arrangements.**

Central depository management – which does not imply the listing of the fund units, or the creation of a secondary market for trade in them – should be considered as essential to the operation of a system infrastructure aimed at connecting the information flows of distributor-intermediaries, product providers (managers) and custodian banks and would completely automate the execution of the subscription and redemption transactions (and relative registrations).

The system infrastructure would therefore act as a single entry point between issuer and distributor intermediaries to facilitate, standardise and streamline relations between them.

The single entry point would not affect the way the financial relationship between the manager and distributor intermediaries is structured, as it would be fully compatible with the maintenance of distribution agreements. But as noted it would ensure the full **automation** of the procedures and thus greater integrity and fluidity of the information flows between the participants in the distribution process.

A system infrastructure hinging on a central depository model in a dematerialised security scenario would complete the process of overcoming the fragmentation of the fund-system and create more efficient operational procedures, including through a significant reduction of **operational risk.**

The institution of a central depository for open-end fund units in a dematerialised security scenario would extend to these products the operating mechanisms already present domestically and internationally for other financial instruments, subject to the special aspects of the distribution activities.

*Expected results*

Reducing the fragmentation of the language, the operating systems and the operational risks would facilitate the creation of a more competitive market in which the **asset management industry** would be induced to open additional distribution channels beyond the parent group.

The **distribution** area could also benefit: the greater openness of the system could facilitate marketing strategies to extend the range of products on offer to reach a broader spectrum of investors, with different levels of sophistication.

A system infrastructure could fully exploit the liberalisation of the regulations introduced by the MiFID for greater modularity of the services, including for investment in mutual funds.

This is especially true with respect to the maximisation of the value added value for the investor resulting from advisory services, as the intermediary will be effectively able – thanks to the wider range of products available – to recommend products to the investor that suit the investor’s risk profile and investment objectives and are compatible with the financial situation.

The beneficial effects for the **investor** will be the improved quality of the products (in terms of management policies or pricing) due to more competition.

The greater openness of the system will also lay the basis for facilitating unit portability, so that investors can turn to the distributors that best serve their particular needs.

The institution of a system infrastructure for investor orders poses the issue of the more operational aspects. Among these it is important to mention: how flexible the infrastructure is; the market conditions that the single entry point operates in; the inclusion of non-Italian harmonised UCITS sold in Italy as part of the domestic central depository system.

#### *System flexibility*

The recouping of efficiency (in terms of reduced fragmentation and operational risk) expected the creation of a system infrastructure must not be accompanied by the introduction of operational rigidities.

To that end, the infrastructure should have a fee policy that aims at reducing costs for industry players and be flexible enough to allow different characteristics of the products, so as to avoid limitations to innovation, and to allow any changes to their features relevant to the subscription procedures to be made promptly (for introduction of a new unit class, fund amalgamation operations, etc....).

#### *The market conditions in which the central manager*

With reference to the market conditions for the single entry point, and therefore the presence of a single party rather than a variety of centralised parties, note that if there were more than one market operator with single entry point functions, there would have to be a mechanism to ensure their interoperability (interlinking) in order to reduce the fragmentation of the operating systems currently used by the asset management industry.

The hearings that the Working Group held indicated that market dynamics gave rise to efficient solutions that all hinge on the single entry

*The non-Italian  
harmonised UCIs*

point and are characterised by special governance structures (to this end the consortium structure of the American NSCC is significant).

Special importance attaches to arrangements for retail non-Italian harmonised UCITS sold in Italy. Thanks in part to the contribution from the experts consulted, it was made clear that there were no technical obstacles to admitting the units or shares of a non-Italian harmonised fund sold in Italy to a central depository system in a dematerialised security scenario. In fact, some of the products sold in Italy have fund units (voluntarily) dematerialised at non-Italian central depositories.

The creation of a central depository system for all the funds sold in Italy would ensure uniformity in managing UCITS order flows regardless of country of origin, especially for “moving” the UCITS units by simple accounting entries, and at the same time operational uniformity with respect to transactions made outside the national territory would be ensured for the previously dematerialised securities abroad. As regards non-dematerialised non-Italian UCITS units, these could enter the central depository system on a direct or indirect basis through the connections between the Italian central depository and the corresponding non-Italian entities.

However, if the Italian single entry point is not to entail a further cost for the providers that would impact on the distribution process, it would be advisable to ensure a high level of substitutability between the functions of the domestic central depository and those currently performed by other institutions that take part in the distribution process.

To that end, the role of the local payment agent could be redefined with special reference to the withholding tax agent function, which the local payment agent has performed to date in the case of regular income payments or redemption of units.

### **5.3. Policy guidelines**

**In conclusion, it appears that system standardisation and the single entry point should not be viewed as alternative or conflicting but as models that can be followed using a “gradual” operational logic, taking account of the market situation and progress in the industry in terms of efficiency and competitiveness in fund processing.**

The entire development process has to be progressive and take place gradually along a **path that is independently promoted by the various stakeholders in the financial industry**, taking account of market developments and the progress already achieved towards greater efficiency and competitiveness of the system as a whole.

*The methods and  
calendar for the  
interventions*

The entire process should be identifiable at its various stages and in how it is implemented. The supervisory authorities will monitor its development, with special regard to the actual start-up and the state of advancement (manner and times of the different stages of implementation of the process). The industry too should envisage periodic checks as part of the work planning process.

**The findings of the monitoring activity will determine the evaluations of the supervisory authorities. The authorities use the power conferred by the law to fuel the process, given its purposes, and also expedite matters.**

*Provisional  
programme*

In order to allow the entire process to be checked, a **provisional programme** was designed setting out the various passages that the industry and the supervisory authorities should take and that must be considered when planning the activities to carry out as needed.

The following is a summary of this provisional calendar:

- a) by June 2010 an operational plan should be prepared clearly setting out: the language to use, the procedures and the standardisation methods (with special regard to the execution times of the processes, the modes of identification of the parties, the substance of the information flows and the monetary transfers between the participants in the fund distribution process, etc.);
- b) by December 2011 the various market operators will have implemented the aforesaid operating plan. This implies the adoption of a single communication language at system level, and uniform procedures for the execution of customer orders in accordance with standard procedures and deadlines.

The planned activities pursuant to the provisional programme may be facilitated:

- a) by aligning the tax on the Italian funds with the tax treatment of non-Italian UCITS sold in Italy. Since the distributors must be recognised as withholding tax agents for the Italian funds, this could also be the case for the non-Italian UCITS, simplifying the functions of the local payment agents during the subscription and redemption procedures;
- b) by progressively increasing the openness of the distribution system of the funds and the quality of services offered by the distributors;
- c) by increasing the quality of the open-end mutual funds, thanks to a stronger focus of product providers on management.

The philosophy underlying this report, and in particular the policy recommendations, is that the future of the asset management industry in Italy depends on the efficiency and competitiveness of the entire system.

## **ANNEXES**

## Annex 1 – List of participants in the working group

Claudio SALINI Giuseppe D'AGOSTINO Maria Antonietta SCOPELLITI Filippo MACALUSO Salvatore LO GIUDICE* Martina TAMBUCCI* Gianluca LEGGIERI* Alessandra TONALI* Giovanna FRATTI*	CONSOB:
Corrado BALDINELLI Lucilla ASCIANO Aldo STANZIALE Costanza IACOMINI Sergio SINISI*	BANK OF ITALY
Angela Maria BRACCI David SABATINI	ABI
Germana MARTANO Oliviero PULCINI	ANASF
Roberta D'APICE Fabio GALLI Deborah ANZALDI*	ASSOGESTIONI
Filippo PARRELLA Marco TOFANELLI	ASSORETI
Michele CALZOLARI Gianluigi GUGLIOTTA	ASSOSIM

\* This participant carried out a role of technical support in the analysis and drafting of the final working Document.

## **Annex 2 – List of persons consulted**

ALLFUNDS BANK

ARCA SGR

AZIMUT

BNP PARIBAS SECURITIES SERVICES

CLEARSTREAM

EUROCLEAR

BANCA FIDEURAM

FINECO BANCA

JP MORGAN

MONTE TITOLI

SCHRÖDERS

SOCIETE GENERALE SECURITIES SERVICES

DEPOSITORY TRUST & CLEARING CORPORATION

PIONEER INVESTMENTS

### **Annex 3 – List of persons interviewed for the cost-benefit analysis**

ALLIANZ BANK FINANCIAL ADVISORS

BANCA FIDEURAM

BIPIEMME GESTIONI SGR

EURIZON CAPITAL SGR

FINECO BANCA

INTESA SANPAOLO

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MONTE DEI PASCHI DI SIENA

PRIMA SGR

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