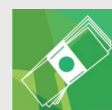


Special report

Investment funds

EU actions have not yet created a true single market benefiting investors



EUROPEAN
COURT
OF AUDITORS

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Executive summary

I Investment funds pool capital and invest it through a portfolio of assets. They play an important role in the Capital Markets Union – by accelerating growth, creating jobs and improving the EU’s autonomy. EU citizens directly hold about a quarter of all funds in the EU, but also have significant indirect exposure to investment funds through life insurance and pension contracts. The EU’s aim is to create a single competitive market providing EU citizens with a wider choice of less costly but reliable investment products and ensuring financial stability throughout the EU.

II Investment funds domiciled in the EU held €18.8 trillion in assets in 2020 of which households own almost two thirds, thus highlighting the need for effective consumer protection. The EU has established a regulatory framework for investment funds to ensure that similar rules apply across the single market. Despite efforts to develop the single market, the investment fund industry remains concentrated in a few Member States. The legal framework mainly consists of directives, which require Member States to implement national rules leading to significant regulatory differences. ESMA, an EU agency, is tasked with ensuring effective and consistent supervision throughout the EU, and with monitoring financial stability risks together with the ESRB.

III Our audit covers the period 2016 to July 2021 and examined how the EU set up a single market for investment funds. We assessed whether the regulatory framework is effective, whether the EU’s work has promoted supervisory convergence among Member States, and whether the EU has effectively mitigated risks to investors, markets and financial stability. This audit identifies weaknesses in the Commission’s legislative approach and ESMA’s actions relating to investment funds and makes recommendations for improvement. It thus helps increase the effectiveness and efficiency of financial supervision and investor protection.

IV We conclude that EU actions have enabled a single market for investment funds to be established, notably through the passporting regime, but that true cross-border activities and benefits for investors remain limited. In addition, the consistency and effectiveness of fund supervision and investor protection are flawed. Minor revisions of the legal framework will not be sufficient to achieve a true single market.

V ESMA has strived to promote supervisory convergence, resulting in slightly improved quality of supervision and fewer divergences. However, ESMA cannot measure this progress, and has limited knowledge of whether an equivalent level of supervision is performed across Member States. Nevertheless, ESMA’s work has

revealed weaknesses in national supervision and some divergent practices. To achieve consistent supervision, it relies on the goodwill of national supervisors and the willingness of its own Board of Supervisors. We found that both preferred soft convergence tools, whose effectiveness has not yet been demonstrated and which often did not result in effective and consistent supervision.

VI EU actions have increased investor protection. For instance, they enhance transparency for investors, in particular on investment risks, performance and costs. However, investors are still not sufficiently protected from undue costs or against biased advice from financial intermediaries. As a result, investors face higher costs, and can be sold less suitable products than is desirable.

VII ESMA and the ESRB monitor and report on systemic risk. So far, no inventory of existing practices in Member States to monitor systemic risk has been carried out. ESMA has not carried out supervisory stress tests as required, but has simulated stress based on market data. The effective monitoring of systemic risks and risks to investors depends on the availability of suitable data. However, there is no harmonised reporting regime for UCITS, and reporting on AIFs lacks details. So far, ESMA and the ESRB have not fully explored the possibility of using existing data collected by central banks, relying instead on less reliable data from commercial providers.

VIII We recommend that the Commission should:

- assess the suitability of the existing framework to achieve the desired objectives;
- consider proposing changes to ESMA's governance structure; and
- streamline data collection and update reporting regimes.

IX We recommend that ESMA should:

- enhance the effectiveness of its convergence work; and
- in cooperation with the ESRB, improve the identification of systemic risk.

X The Commission and ESMA should:

- better protect investors against undue costs and misleading information.

Introduction

The investment funds market in Europe

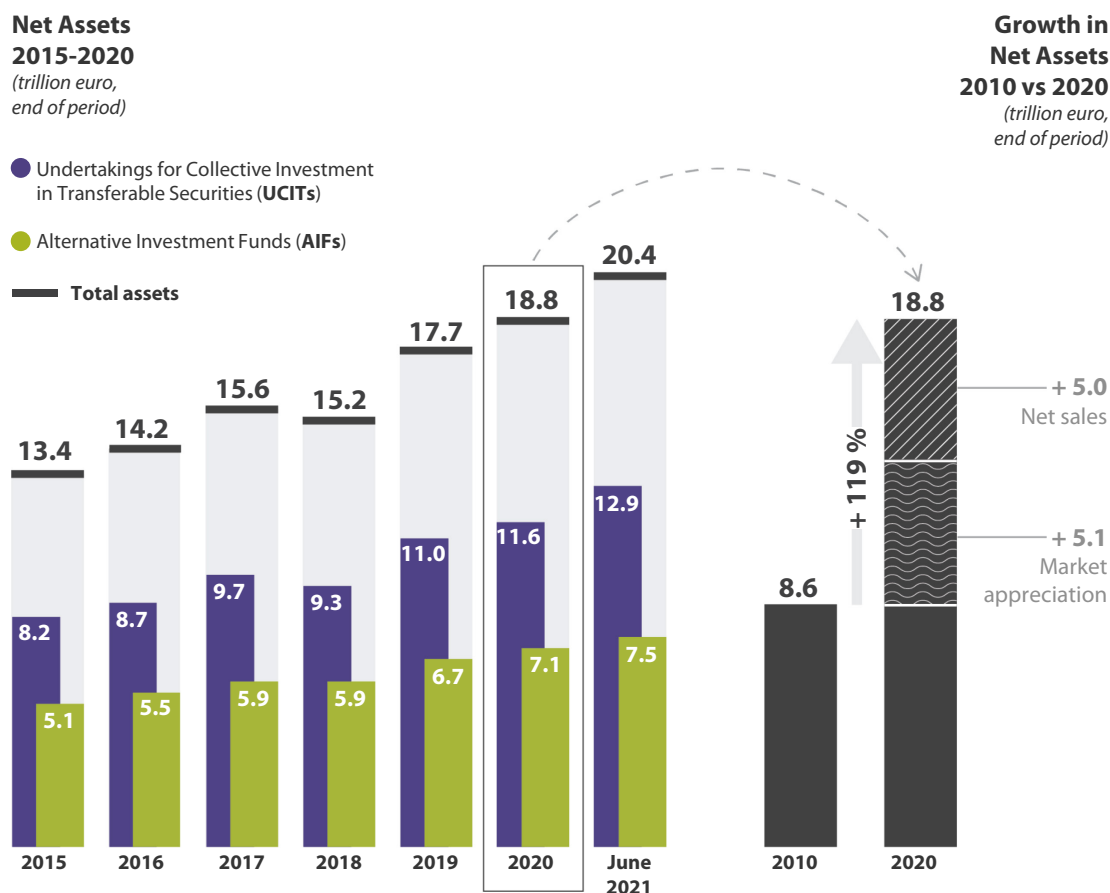
01 Investment funds pool investors' capital and invest it collectively through a portfolio of assets such as stocks, bonds and real estate, in accordance with a defined investment policy and with the principle of spreading risk. They play an important role in the Capital Markets Union, the EU's initiative to get investments flowing across the EU, thus accelerating growth, creating jobs and improving the EU's autonomy. The aim is to create a single competitive market and provide investors with a wider choice of less costly but reliable products.

02 At the end of 2020, the net asset value (NAV) of the 64 000 investment funds domiciled in the EU was €18.8 trillion, which makes the EU the second-largest market for investment funds in the world in terms of assets under management, behind the US. More than 60 % of this amount (€11.6 trillion) was invested in undertakings for collective investment in transferable securities (UCITS), mostly targeted at retail investors. Alternative investment funds (AIFs), representing €7.1 trillion in NAV, include all funds other than UCITS (i.e. real-estate investment funds, private equity funds, certain money-market funds, hedge funds, and other funds). This type of fund is mainly aimed at professional investors.

03 European investment funds have been steadily growing in recent years. Between 2011 and 2020, their NAV increased by 119 % (i.e. more than €10 trillion), and net inflows were recorded in each year as the value of new purchases continuously exceeded redemptions. About half of this growth can be explained by net sales of investment funds, and the other half by market appreciation (see [Figure 1](#)). Since the Alternative Investment Funds Managers Directive (AIFMD)¹ was adopted in 2011, the NAV of EU AIFs has grown at a faster pace than that of UCITS, increasing its market share from 27 % of EU funds at the end of 2010 to 38 % ten years later.

¹ [Directive 2011/61/EU](#) of 8 June 2011 on Alternative Investment Fund Managers.

Figure 1 – Net assets of European investment funds by type of fund (2015-2020) and their growth in net assets (2009-2020)

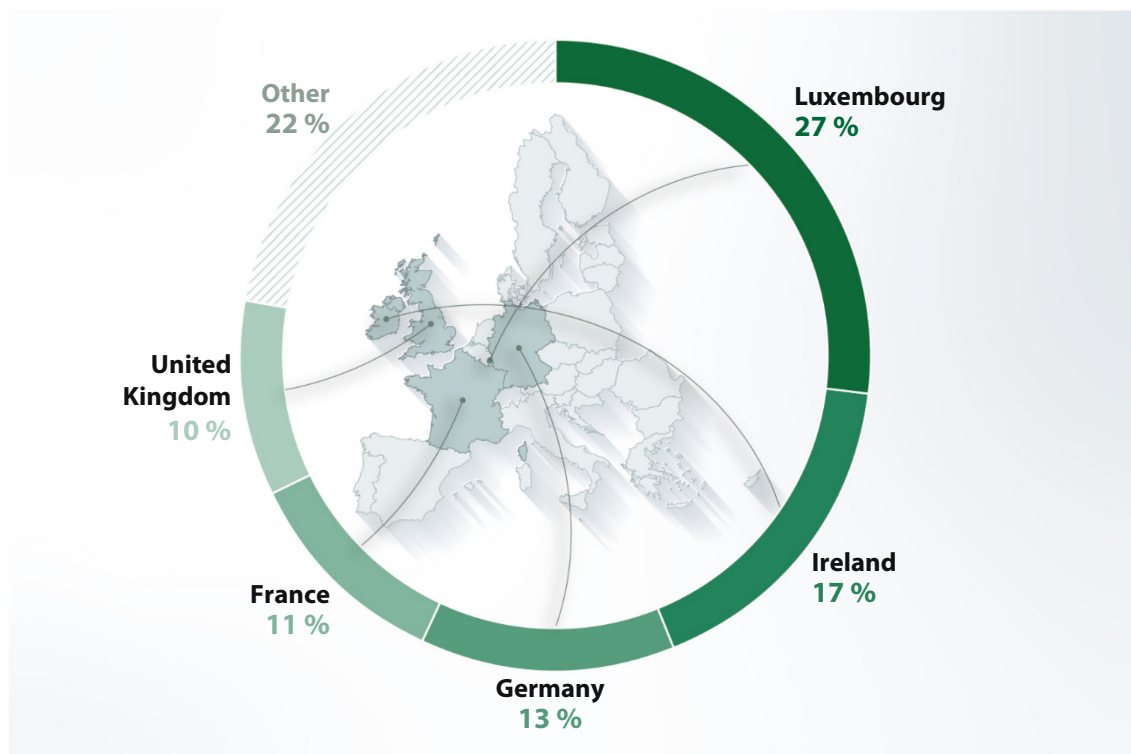


Source: EFAMA Fact Book 2020, p. 8.

04 Although the size of EU-domiciled funds has grown, they continue to be much smaller than their US equivalents. In addition, most of the world's biggest asset managers continue to be based in the US. Only two of the world's 20 biggest asset managers are headquartered in the EU.

05 The vast majority of European investment funds are domiciled in only a few countries. In 2020, almost 80 % of all net assets under management were managed by funds in Luxembourg (€4.70 trillion), Ireland (€3.08 trillion), Germany (€2.39 trillion), France (€1.97 trillion) and United Kingdom (€1.75 trillion) (see [Figure 2](#)). In the case of UCITS, more than half of all net assets are domiciled in Luxembourg or Ireland. 70 % of all assets under management in the EU were held by funds authorised or registered for distribution in just one Member State. 37 % of UCITSs and 3 % of AIFs were registered for distribution in more than three Member States.

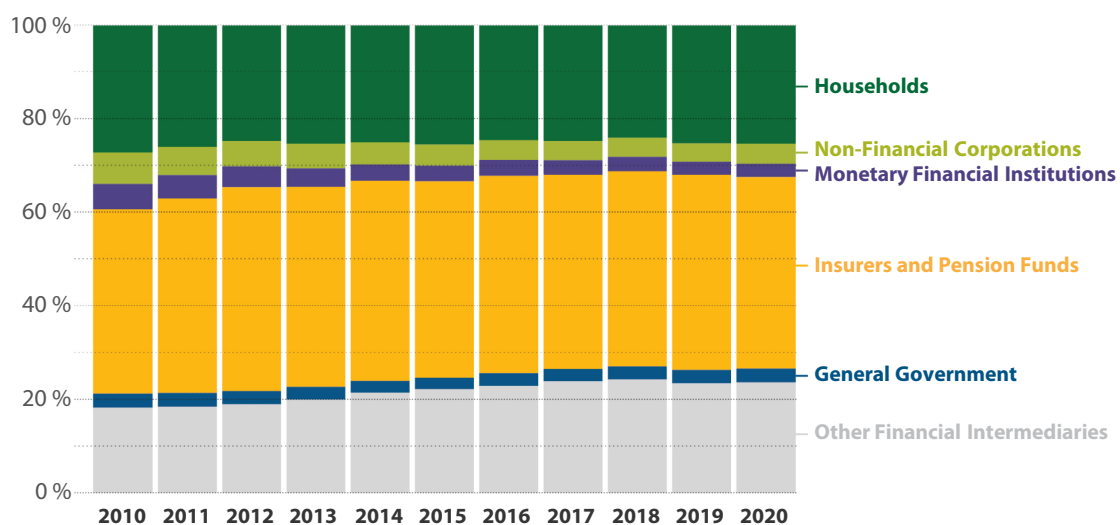
Figure 2 – Breakdown of net assets by domicile in 2019 in the EU



Source: ECA, based on data from EFAMA.

06 Institutional investors hold almost two thirds of the NAV of investment funds. Households directly hold about a quarter of all funds (see [Figure 3](#)), but also have significant indirect exposure to investment funds through life insurance and pension contracts.

Figure 3 – Investment fund ownership by sector (percentage share)



Source: EFAMA, Fact Book 2021.

07 Despite near-zero interest rates, European households continue to keep a large part (37 % at the end of 2020) of their financial assets in deposits, which is more than twice as much as in the US (16 %). Investment funds increased their share from 8.3 % in 2011 to 12.1 % in 2017.

Regulatory framework

08 The principal legislation is the Directive on Undertakings for Collective Investment in Transferable Securities (the UCITS Directive)² and the Alternative Investment Fund Managers Directive (the AIFMD). These directives differ in scope and in substance. The UCITS Directive is a product regulation, while the AIFMD focuses on requirements for managers. Both directives are minimum harmonisation directives that allow national lawmakers to establish more and stricter rules than the minimum standards stipulated by EU law. The Markets in Financial Instruments Directive (MiFID II) stipulates business conduct and organisational requirements for investment firms, i.e. those institutions that sell funds to retail clients.

09 The original UCITS Directive has been revised several times and the Commission proposed another amendment on 25 November 2021 in the context of the AIFMD review. In 2019 amendments to the UCITS and AIFM framework were introduced with the aim of removing regulatory barriers to the cross-border distribution of investment funds (the cross-border package). In addition, EU law covers specific types of funds, e.g. money market funds (MMFR).

10 One of the key objectives of the UCITS and AIFM Directives is to facilitate cross-border activities by fund managers and investment funds. They introduced management and marketing passports for funds and fund managers domiciled in the EU:

- o The **management passport** allows a UCITS management company or AIF manager (AIFM) which has been authorised in a Member State to carry out its business in other EU Member States, either with the freedom to provide services or by establishing a branch. While such cross-border activity is subject to a notification procedure between the national competent authorities (NCAs) in the Member

² Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast).

States involved, the fund manager does not have to undergo a further authorisation process.

- The **marketing passport** allows UCITS or AIFs which have been authorised by the NCA in an EU Member State to be marketed in other EU Member States on a cross-border basis without the need for authorisation by the host Member States' NCAs. While the UCITS marketing passport allows the marketing of UCITS to retail and institutional investors, the AIF marketing passport is limited to marketing to professional investors only. Similar to the management passport, authorisation is replaced by a notification procedure between NCAs in different EU Member States.

Responsibilities of the EU and Member States

11 The European system for fund supervision is made up of a number of European and national stakeholders. While EU bodies are responsible for the underlying legislative and coordination work, each Member State is responsible for the transposition of EU law and the supervision of investment funds within its territory:

- The European Commission, in particular its Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA), is responsible for policy initiatives regarding the financial sector, including proposing directives and regulations.
- The European Securities and Markets Authority (ESMA) is an independent EU agency responsible for investor protection and the promotion of stable and orderly financial markets. ESMA's responsibilities include supervisory convergence, and identifying risks to financial stability and investors, comparable to the other ESAs with which it shares corporate structures and related challenges.
- The European Systemic Risk Board (ESRB) is responsible for macro-prudential oversight of the EU financial system. It works closely with ESMA and the other supervisory authorities.
- Responsibility for supervising funds and fund managers lies with the national competent authorities on the basis of national laws that must comply with the minimum standards set by EU law or of directly applicable EU law. NCAs are voting members on the Board of ESMA, and participate in the ESRB's work.

Audit scope and approach

12 We performed this audit to respond to the high level of public interest in investment funds which are particularly important for the EU to develop its Capital Markets Union. They are prone to risks to investors and to financial stability. Our audit covers the period 2016 to July 2021.

13 The audit examined whether the EU has created a true single market for investment funds that ensures investor protection and financial stability. We also addressed the following sub-questions:

- Have EU actions established a suitable regulatory framework to enable the creation of a true single market for investment funds?
- Have EU actions fostered supervisory convergence?
- Do EU actions effectively protect investors?
- Do EU actions assess and mitigate risks to financial stability effectively?
- Do EU authorities have reliable data available to identify risks to financial stability and investors?

14 Our audit criteria are drawn from the international standards set by IOSCO, and from EU law (in particular the UCITS and AIFM Directives, the MMF Regulation and the ESMA Regulation). In some instances we compare the EU market to that of the United States, the most developed capital market.

15 The focus of the audit was on the actions undertaken by the three auditees: the Commission, ESMA, and the ESRB. We conducted interviews with staff from these institutions, and examined relevant documentation. In order to gain additional insights, we interviewed representatives of five NCAs, several national asset management associations, and three consumer organisations. We also met with the EBA and EIOPA. To complement this information, we conducted an electronic survey of the NCAs, Ministries of Finance, and investment fund associations in all 27 member countries in order to obtain the views of these key stakeholders. We did not audit the NCAs directly but covered their role as ESMA's Members.

Observations

EU lawmakers' objectives have only been achieved to a limited extent

EU lawmakers set ambitious objectives for a single market for investment funds

16 The Commission and EU co-legislators have set ambitious objectives for a single market for investment funds. In 1985, the first UCITS Directive was adopted to create the conditions to allow funds and fund managers domiciled in one Member to market their funds across the EU without supervision in other Member States. The co-legislators aimed to:

- make it easier to market funds in other Member States;
- ensure more effective and more uniform protection for investors; and
- approximate the conditions for competition.

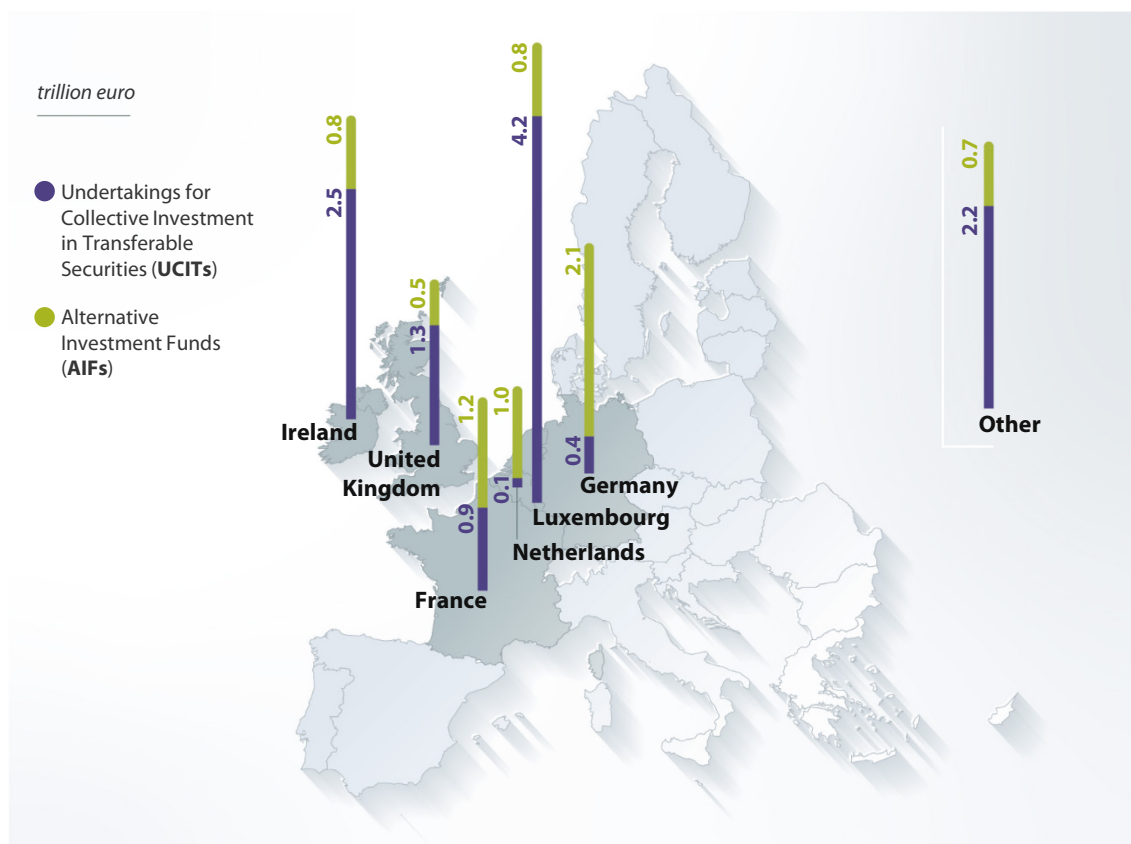
17 It was expected that a more integrated investment-fund market would offer EU investors more choice, and that it would create new business opportunities for the fund industry. The relevance of these general principles and the importance of ensuring a level playing field were reiterated when the AIFMD was adopted in 2013³.

The passport regime has not created a true single market

18 The passport regime contributed to a concentration of fund domiciles. EU actions have established marketing and management passports for funds (see paragraph [10](#)). Nevertheless, the European fund market remains fragmented, and the majority of funds are domiciled in a few countries (see [Figure 4](#)).

³ Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers, recitals.

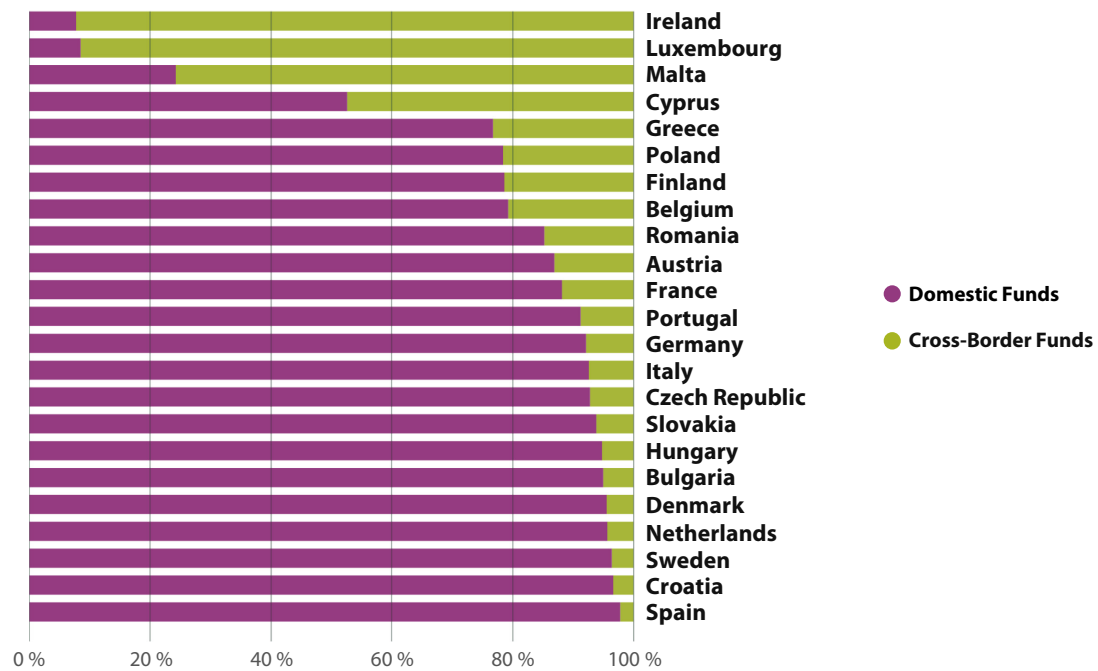
Figure 4 – The NAV of UCITS and AIFs by country of domicile (trillion euros)



Source: ECA, based on EFAMA figures.

19 In most Member States, funds are mainly distributed in their domestic market. Conversely, funds domiciled in a few countries are predominantly sold abroad (see [Figure 5](#)). According to European Fund and Asset Management Association (EFAMA), local funds account for 67 % of fund ownership in Europe, compared to 73 % ten years ago.

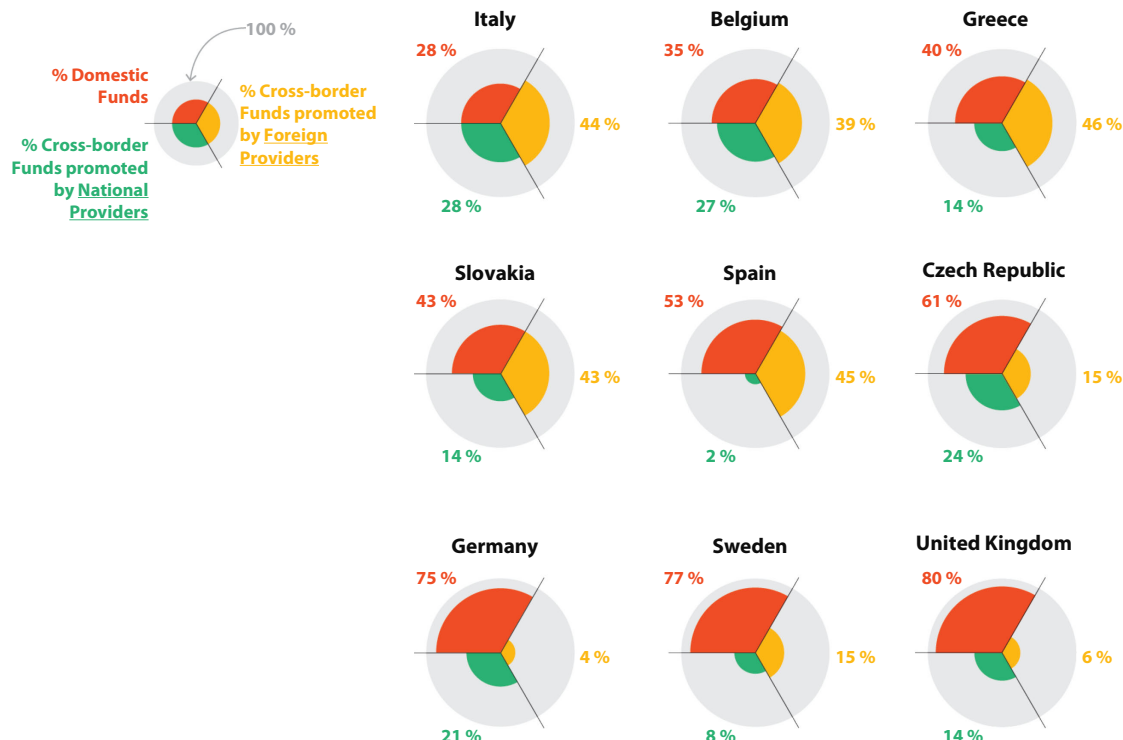
Figure 5 – Domestic funds vs cross-border funds



Source: EFAMA, Factbook 2021, graph 3.16, p. 50.

20 In several EU Member States, most cross-border funds are sold by national asset managers, not by foreign asset managers. A breakdown of investment fund ownership, including cross-border funds promoted by national providers, is presented in [Figure 6](#).

Figure 6 – Fund ownership and “true” cross border funds



Source: EFAMA Fact Book 2021, p. 45.

21 The Commission calls this phenomenon “round-trip funds”, a category of funds that it does not regard as “true” cross-border funds. According to ESMA, funds are often notified for cross-border marketing, but not necessarily marketed. Thus, actual cross-border marketing is more limited than the figures suggest. In its impact assessment accompanying the cross-border package proposals in 2018, the Commission concluded that round-trip funds do not represent a real deepening of the single market, nor an increase in investor choice, and considered instances where a fund is marketed in at least one Member State outside the home market of its manager and domicile to be a better indication of cross-border activity⁴.

22 Based on the Commission’s impact assessment accompanying the cross border package⁵, the co-legislators identified divergent regulatory and supervisory approaches as a reason for the fragmentation of EU fund markets. They also observed that barriers to cross-border marketing prevented funds from being marketed in other

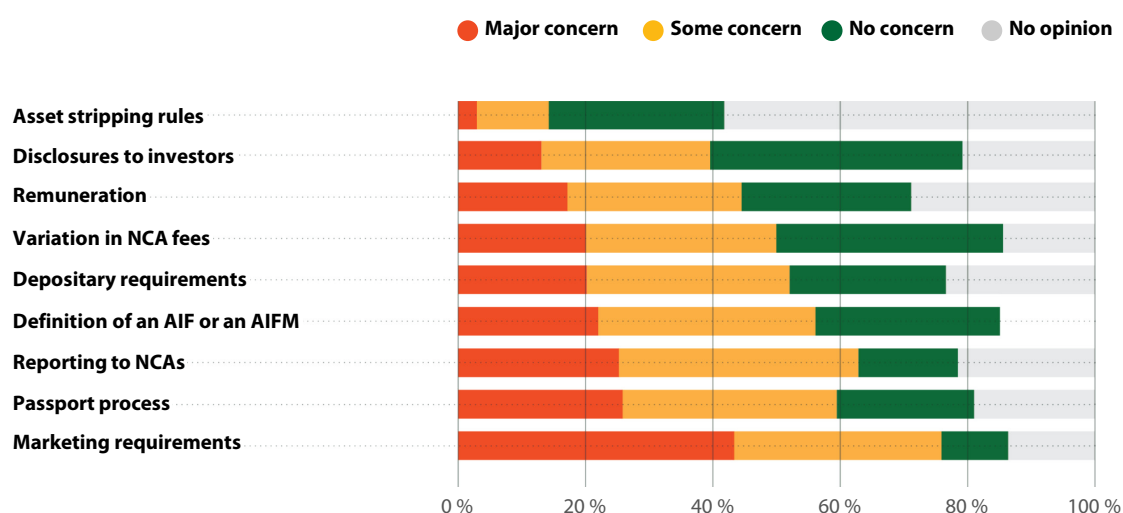
⁴ SWD/2018/054 final, 12.3.2018, p. 12.

⁵ SWD/2018/054 final, 12.3.2018, p. 7 and 14.

Member States⁶. Accordingly, the legislative package focused on addressing diverging national requirements and regulatory practices regarding the use of EU passports, including marketing requirements, regulatory fees, and administrative and notification requirements.

23 While divergent approaches persist we found that the Commission did not demonstrate that the resulting market entry barriers are indeed the main cause of market fragmentation and the low number of true cross-border funds. We note that in a 2018 report on the operation of the AIFMD, almost half of the participants surveyed stated that the AIFMD is not applied consistently across the EU. Thus, the problem is not with the legislation, but with its application in Member States. However, this inconsistency was not a major concern for most of the participants in the report (see [Figure 7](#)).

Figure 7 – Concerns about inconsistent application of the AIFMD



Source: Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD)⁷.

24 As the legislative instrument used by the co-legislators, directives establish minimum standards. The respective EU directives explicitly stipulate that, as a general rule, a home Member State can establish rules that are stricter than those laid down in this Directive⁸. The de Larosière report highlighted that directives do not achieve the necessary level of harmonisation and recommended to avoid future legislation that

⁶ [Regulation \(EU\) 2019/1156](#) of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings, recital 1.

⁷ [FISMA/2016/105\(02\)/C](#), 10 December 2018.

⁸ [UCITS Directive](#) recital 15; [AIFM Directive](#) recital 17.

permits inconsistent transposition and application⁹. Half of the NCAs that responded to our survey said that the laws in their Member States did indeed impose stricter rules. We note that uniform rules in the form of regulations might be more appropriate for creating a level playing field across the EU.

25 Furthermore, we observe that directives have triggered a race to the bottom. The practice of “gold plating” (i.e. the setting of higher standards) and our discussions with stakeholders suggest that countries which simply transpose the minimum requirements prescribed in the directives have a competitive edge as countries of domicile compared to countries that have higher standards. Combined with a favourable tax regime and the possibility of transferring profits, this creates strong incentives for the fund industry to engage in forum-shopping, leading to distortions of competition.

The impact of legislative initiatives is limited

26 We found that the Commission’s own analysis recognizes the limitation to the impacts of its legislative proposals. The Commission identified significant drivers, such as taxation, local demand and the distribution network, that affect where asset managers choose to distribute their investment funds, but which cannot be addressed by EU law.

27 Moreover, we note that a main problem identified by the Commission itself is not the legal framework *per se*, but that host countries erect market entry barriers. The Commission has tools to address cases where Member States create market entry barriers or where NCAs potentially breach EU law, namely its power as guardian of the Treaties to start infringement procedures or to request ESMA to start a ‘breach of Union law’ procedure. Nevertheless, the Commission concluded that the remaining barriers can be most efficiently addressed (by legislation) at EU level¹⁰.

28 Impact assessments, such as the one for the cross-border package, often include an ex-post evaluation of the provisions affected by the initiative. However, the review of the UCITS Directive that was initially expected by September 2017 has been delayed.

⁹ [The High-Level Group on Financial Supervision in the EU](#), 25 February 2009, recital 100-109 and recommendation 10.

¹⁰ [SWD/2018/054 final](#), 12.3.2018, p. 14.

29 The Commission has never conducted a comprehensive fitness check of the complete legal framework governing investment funds. No such check is planned in the near future. The only fitness check partially covering investment funds was a fitness check of EU supervisory requirements that was carried out by the Commission in 2017-2019¹¹.

30 The Commission establishes multi-annual Strategic Plans and annual Management Plans, and reports on the achievement of its objectives. We found flaws in the Commission's performance measurement. For example, the main result indicator for UCITS in the 2016-2020 Strategic Plan was the share of cross-border UCITS funds with respect to the total number sold in the EU. We note that the Commission later lowered the bar for what constitutes a cross-border fund from funds sold in at least five Member States to three.

31 The Strategic Plan 2020-24 mainly contains specific horizontal objectives and related result indicators. We found that most interim milestones and targets set for the result indicators in the Strategic Plan 2020-24 are not specific. Indicators must be relevant, accepted, credible, easy to monitor and robust, based on Commission's internal control framework. Terms such as "increase", "positive trend" and "decrease" are used, but without specifying how much of an increase or decrease would be considered satisfactory. Moreover, the targets for some result indicators are unambitious. For example the decrease in costs for retail investors had already been met when setting the target.

Transposition has not always been timely

32 The Commission checks the timeliness, completeness and conformity of the transposition of directives by Member States. Late and/or incorrect transposition may prevent the creation of a level playing field and hinder the proper functioning of the single market, and the Commission is supposed to launch infringement procedures to urge Member States to act when they are late in adopting the required measures.

33 As regards the UCITS Directive and the AIFMD, only 12 Member States notified transposition within the deadlines. In addition, it then took another eight years before the Commission considered the transposition of the AIFMD to be complete.

¹¹ European Commission, [Fitness check of EU supervisory requirements](#), SWD (2019) 402 and 403.

ESMA has stepped up its efforts to foster supervisory convergence and to promote effective supervision, but progress is limited

34 As described above (see paragraph 08), NCAs supervise investment funds and their managers, as well as investment firms and other financial intermediaries, on the basis of harmonised national laws, but not on the basis of uniform standards. Thus, legal requirements and regulatory practices can still differ from one Member State to another.

35 Against this background, EU lawmakers entrusted ESMA with:

- contributing to ensuring the consistent, efficient and effective application of applicable EU laws; and
- fostering convergence of supervisory practices to further strengthen consistency in supervisory outcomes across NCAs with the aim of establishing a common supervisory culture¹².

36 Supervisory convergence does not mean a one-size-fits-all approach, but rather consistent and effective implementation and application of the same rules, and sufficiently similar approaches for similar risks. The overall goal is to strive for comparable regulatory and supervisory outcomes. This, however, does not mean that it is sufficient for comparable outcomes to be reached, irrespective of the supervisory approaches used.

37 The de Larosière report highlighted the importance of convergence for EU financial markets¹³. In 2014, the IMF, the Commission and the Parliament published reports on the functioning of the European System of Financial Supervision. These acknowledged ESMA's contribution to establishing a single rulebook, but suggested increasing the focus on supervisory convergence¹⁴.

38 The Commission also emphasised that more effective and consistent supervision is essential to eliminate possibilities for regulatory arbitrage, and that ESMA plays a

¹² Article 1 of the [ESMA Regulation](#).

¹³ [The High-Level Group on Financial Supervision in the EU](#), 25 February 2009.

¹⁴ [ESMA Strategic Orientation 2016-2020](#), ESMA/2015/935, p. 3.

key role in fostering capital-market integration¹⁵. This statement was reiterated in the context of the 2019 revisions of the ESA Regulations. EU lawmakers emphasised that “further progress in supervisory convergence is therefore particularly urgent to complete the Capital Markets Union”¹⁶.

ESMA has the tools to foster supervisory convergence

39 To foster convergence, ESMA has many tools at its disposal which can be grouped into three categories: preparatory, implementation and assessment/remediation tools. An overview is provided in [Figure 8](#). ESMA has created further tools, such as case discussions and CSAs.

Figure 8 – Overview of ESMA’s supervisory convergence tools



Source: ECA, based on ESMA Regulation.

ESMA has stepped up its convergence work

40 ESMA has stepped up its efforts in the field of supervisory convergence. In its Strategic Orientation 2016-2020, ESMA had pledged to commit more resources to promote supervisory convergence, clarified its objectives, and targeted a number of specific areas for its convergence work. ESMA has since increased the number of its staff working on convergence in this field from 5 (5.7 FTE) to 8 in 2020 (8.7 FTE).

41 In 2020, ESMA created a framework for a more risk-based approach to its supervisory convergence activities. A Heatmap identifies the relevant risks, but contains little information on uneven application of the rules and divergent practices. Nevertheless, the Heatmap is a positive step. It has been effective in identifying the areas for risk-based supervision across the EU, but less so in identifying topics for

¹⁵ COM(2017)292 final, 8.6.2017, chapter 4.1.

¹⁶ Recital 7 of [Regulation \(EU\) 2019/2175](#) of 18 December 2019.

further convergence work. We also found that ESMA was successful in implementing a more systematic and evidence-based approach to convergence work.

There is limited evidence of impacts, and no mechanism in place to measure effectiveness

The effectiveness of guidelines is not demonstrated

42 In the past, preparatory tools such as guidelines have been ESMA's most important convergence tools. Guidelines are subject to the 'comply or explain mechanism', i.e. NCAs need to notify ESMA whether they intend to implement them or not. ESMA publishes compliance tables for every guideline, and these are updated regularly¹⁷.

43 We found that NCA compliance is not always ensured. ESMA's internal guidance¹⁸ requires it to verify and assess the application of guidelines. While ESMA asks NCAs annually about their compliance with guidelines, it only checked NCA's actual compliance once through a peer review. It revealed that the guidelines had been ineffective in promoting supervisory convergence and that, in general, NCAs had complied as notified only to a limited extent (see [Box 1](#)).

Box 1

Findings from the Peer Review on the Guidelines on ETFs and other UCITS

The peer review covered the six major fund domiciles in the EU and revealed that none of them had implemented the guidelines fully. Two NCAs were partially or insufficiently compliant. In these countries, ESMA even qualified supervisory practices as being in "contravention of the guidelines and not consistent with a level playing field for UCITS in the Single Market". Overall, it identified significant divergence in the application of the guidelines, and several areas where the objective of supervisory convergence had not been achieved.

¹⁷ [ESMA Notifications of Compliance with Guidelines - Overview Table](#).

¹⁸ Internal Guidance - Guidelines compliance notification process, ESMA42-110-888, paragraphs 35 and 38.

Common supervisory actions have fostered regular exchanges among supervisors, and allowed ESMA to coordinate NCAs' supervisory activities

44 Common supervisory actions (CSAs) are a convergence tool that has been developed by ESMA, as have supervisory coordination networks and exchanges with NCAs based on complaints. ESMA values these tools due to their forward-looking nature, and because they help to identify convergence issues. ESMA has already launched several CSAs related to UCITS and MiFID II.

45 CSAs and coordination networks are tools that allow supervisors to share experiences and to learn from each other, leading to the conclusion that they should contribute to a common supervisory culture over time. CSAs also help ESMA to identify divergences in supervisory practices and potential shortcomings in NCAs' supervision, and to provide guidance in the practical application of EU law, e.g. where individual NCAs still lack a sound methodology.

46 CSAs allow ESMA to focus supervisory attention on specific risks, and to promote and coordinate supervisory activities. This may result in a heavy workload, a concern that was raised by several NCAs in our survey.

Assessment and remediation tools have been very rarely used, despite their potentially bigger impact

47 Peer reviews are a potentially powerful tool, but are rarely used in the area of investment funds. ESMA intends to use them more in the near future, but also highlighted resource limitations and the need to maintain a balance across all sectors under its mandate. What distinguishes a peer review from other convergence tools is that it requires ESMA to perform and publish a formal assessment not only of the level of convergence reached in terms of supervisory practices and enforcement, but also of supervisory capacity. It allows ESMA to issue guidelines and recommendations to address any weaknesses detected. Since it was set up in 2011, ESMA has only performed two peer reviews of investment funds: one concerning the Money Market Fund (MMF) Guidelines in 2013 and another relating to the Guidelines on ETFs and other UCITS issues in 2018¹⁹.

48 ESMA also has two remediation tools at its disposal: mediation and 'breach of Union law' procedures, which empower it to investigate and remedy alleged breaches of Union law or to settle disagreements between NCAs. There was one case where

¹⁹ [ESMA/2013/476](#) of 15 April 2013 and [ESMA42-111-4479](#) of 30 July 2018.

ESMA successfully assisted two NCAs in reaching a settlement of a disagreement. In a few cases breach of Union law investigations were started informally. There has been one formal 'breach of Union law' procedure, which resulted in a change in the NCAs' practices.

ESMA faces challenges to use its tools effectively

49 When it comes to using these powers efficiently and effectively, ESMA faces a number of challenges. ESMA depends on NCAs' willingness to provide input, technical expertise and staff who participate in ESMA's convergence work. The same holds true for the EBA and EIOPA, as our audits of these agencies have shown²⁰. ESMA has taken steps to ensure that NCA participants have the necessary expertise. However, NCA participation in ESMA's convergence activities is largely voluntary – apart from peer reviews, mediation and 'breach of Union law' procedures, and this sometimes hampers the effectiveness of ESMA's work.

50 We found that most NCAs participate in and contribute to ESMA's work, but that some NCAs are more reluctant. For example, in the case of CSAs, smaller NCAs tend to be more active in presenting cases, whereas some larger NCAs prefer a more passive approach. Some NCAs did not respond to ESMA staff's calls to actively participate and present cases, e.g. NCAs that had never used their sanctioning powers did not contribute to a related ESMA workshop in 2020.

51 ESMA's decision-making body consists of NCA representatives. While the latter are required to act in the sole interest of the EU as a whole, this is not always ensured. The Commission's proposal to address this corporate governance issue in the context of the ESA review was rejected. The most obvious conflict of interest has been addressed: NCAs may no longer participate in the discussion and vote on 'breach of Union law' recommendations that concern themselves. ESMA's mediation rules similarly address conflicts of interest. However, all convergence work concerns NCAs since it is their supervisory practices and outcomes that are targeted. This is also true of ESMA's efforts to foster the efficiency and effectiveness of supervision.

52 ESMA depends on the willingness of NCAs. One example is the responsibilities of home and host authorities in a cross-border context – a prominent and recurrent item on ESMA's convergence agenda (see [Box 2](#)). ESMA has only been partially effective in promoting the smooth operation of EU passports for marketing and management, and

²⁰ ECA [special report 29/2018](#) and [special report 10/2019](#).

thus ESMA has not been able to eliminate supervisory practices that create market entry barriers.

Box 2

Home host responsibilities are still under discussion

In 2017, ESMA and, in 2019, the Joint Committee of the ESAs clarified the existing rules and respective roles. Additional discussions were held in various work streams and a workshop, in 2020. Nevertheless, the passporting regime, which stipulates that home authorities are solely responsible for supervising fund managers and funds, is not fully respected while the host authorities' role is limited to ensuring compliance with local conduct roles.

53 We also note that all convergence issues that ESMA highlighted in its letter to the Commission on the AIFM Directive review²¹ had been extensively covered by convergence work. This demonstrates that ESMA's endeavours have only been effective to a limited extent.

54 Another example is delegation. Both the UCITS and AIFM Directives allow management companies to delegate functions to third parties. However, supervisory approaches and outcomes continue to differ in terms of the extent of delegation permissible, as well as the functions that may be delegated, according to ESMA (see [Box 3](#)).

²¹ ESMA Letter on AIFMD Review, ESMA34-32-550, 18 August 2020.

Box 3

Extent of delegation

ESMA highlighted that portfolio management in some Member States is largely or even entirely delegated to third parties within or outside the group of the AIFM or UCITS management company, which is potentially outside the EU. In these cases, the majority of operational staff performing portfolio/risk management, administration and other functions work on a delegation basis for the relevant funds, and are therefore not directly employed by the authorised AIFM or UCITS management company, according to ESMA, and a large amount of the management fees are paid to delegates. For ESMA, such (market) practices in some Member States raise the question whether those AIFs and UCITS can still be effectively managed by the licensed AIFM or UCITS management companies.

Source: ESMA Letter on AIFMD Review, ESMA34-32-550, 18 August 2020.

55 We also observed that ESMA faces some resistance from NCAs in its efforts to enhance transparency. Mandatory publications such as the Annual Report on Sanctions or the Annual Statistical Report on the Performance and Costs of EU Retail Investment Products provide valuable information, including insights into differences among Member States in terms of market realities and the intrusiveness of supervision. However, there is a significant NCA resistance when it comes to publishing the results of CSAs. The final reports on CSAs have never been published.

NCAs prefer less intrusive preparatory tools that are not so effective

56 In the past, ESMA primarily used guidelines, opinions and Q&As. We found evidence that these preparatory tools are not very effective in promoting supervisory convergence. Recently ESMA focussed more on implementation tools, such as coordination networks and CSAs.

57 Almost half of the NCAs considered the more intrusive tools, such as ‘breach of Union law’ procedures and mediation, not to be useful and they clearly preferred preparatory tools. The former have almost never been used by ESMA. However, these powers would allow ESMA to directly impact supervisory actions and outcomes in individual cases, or to address instances of non-application or incorrect application of EU law.

ESMA has no mechanism in place to measure effectiveness

58 ESMA's annual work programmes set objectives but predominantly describe planned activities rather than defining specific outputs or verifiable objectives. In terms of tools, they demonstrate a preference for fostering exchanges between supervisory practitioners on supervisory practices by discussing specific real-life cases or the newly introduced CSAs. This is a useful approach to gain a better understanding of supervisory practices that may contribute over time to the development of a common supervisory culture.

59 The fact that supervisors from different NCAs talk to each other, share experiences, and potentially learn from each other is in itself an important achievement. We found that ESMA had some success in promoting common approaches and enhancing the quality of supervision where it initiated, coordinated and supported specific supervisory activities to address individual risks across the EU, e.g. through CSAs. However, ESMA has little evidence that its activities have significantly reduced existing divergences.

60 We acknowledge the complexity of measuring the impact of ESMA's convergence work. However, ESMA's current output-focused performance measurement (including new outcome-focused key performance indicators introduced in 2019) does not make it possible to measure the extent to which it has contributed to reducing existing divergences in supervisory practices and outcomes. ESMA is not in a position to assess the level of divergence, except in some areas where it has conducted peer reviews or case discussions and CSAs. Moreover, ESMA has an incomplete picture of how NCAs apply EU law in practice. This picture is largely based on what NCAs share. ESMA has no first-hand insights into NCAs' supervisory activities, nor any access to actual evidence, e.g. in the form of supervisory files.

ESMA's work has revealed weaknesses in supervision and potential distortions of competition

61 Strong and rigorous enforcement of securities laws is fundamental to fostering investor confidence, according to the IOSCO Core Principles²², the global standards for securities regulation. The UCITS and the AIFMD contain a comprehensive set of regulatory powers for dealing with infringements of regulatory requirements by funds

²² [Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation](#), May 2017, Section C. Principles relating to enforcement, 1. Preamble, p. 63.

and fund managers. These range from administrative sanctions to cease-and-desist orders and even the withdrawal of licences, and allow for effective law enforcement.

62 ESMA's work shows that the quality of supervision differs between Member States. ESMA has been effective in increasing the NCAs' focus on monitoring, and has ensured that there are common approaches as far as information gathering (including identifying non-compliance with regulatory requirements by the industry) is concerned. ESMA's work on closet indexing and on cost and fees, as well as the CSA on liquidity risk management, are good examples.

63 Moreover, we found that ESMA has had much less impact on supervisory practices and outcomes concerning NCAs' follow-up in cases where its activities revealed non-compliance with regulatory requirements. The insights ESMA gained from its convergence work show that there is a general lack of enforcement activities concerning all NCAs in the EU, albeit to a different degree.

64 We found that NCAs are generally reluctant to use formal supervisory powers, despite ESMA's efforts to promote their use. Our analysis of internal ESMA documents shows that fund managers who breach regulatory requirements merely run the risk of receiving a request to comply from the NCA, being asked to repay fees that were collected unlawfully, or at worst getting a small fine.

65 For example, ESMA's Annual Reports on the use of sanctions for UCITS indicate that sanctioning powers are not used equally among NCAs, and that, except for certain NCAs, the number and amount of sanctions issued at national level is relatively low²³. In 2020, 13 NCAs did not impose any sanctions. ESMA's activities as referred to above reveal similar weaknesses in enforcement.

66 Our examination of internal reports of ESMA shows that there have been instances of weak enforcement by NCAs, thereby not meeting their obligations. We found that ESMA, despite its efforts, has not been successful in promoting effective enforcement of Union law. In some cases, NCAs explained that the legal requirements in their country are not clear enough, indicating problems with either the transposition or the application of the directives in the respective Member States. In our view, cases could potentially have been addressed by 'breach of Union law' procedures, using ESMA's policing role.

²³ ESMA press statement.

67 One of the objectives of promoting supervisory convergence is to prevent competition distortions and regulatory arbitrage stemming from different supervisory practices, and to ensure that financial activity is not shifted to countries with lax supervision. ESMA identified divergent practices in areas such as delegation that have the potential to result in such distortions.

68 This was a concern driving ESMA's Brexit-related work. In this regard, we found that ESMA had been able to set common supervisory standards for the authorisation (including in the area of delegation) of funds and fund managers that no longer had access to the single market. ESMA had established a Supervisory Coordination Network that discussed 250 individual cases across different sectoral areas, including investment management. We found that, through extensive engagement before supervisory decisions were taken, ESMA contributed to preventing such competition distortions from materialising.

The Commission and ESMA have taken steps to better protect investors, but costs remain high

69 Investment products are complex, and it can be difficult to compare them or fully grasp the risks they involve, in particular for non-professional (retail) investors. Retail investors should therefore be adequately informed about potential risks. The legal framework of the EU aims to reduce the risk of mis-selling where retail investors are sold financial products which do not fit their needs or expectations²⁴.

EU legislation includes many measures to protect investors

70 EU legislation to protect investors is spread out across a large number of Regulations, Directives, Commission delegated acts and ESMA guidelines. Some of these measures are included in the UCITS and AIFMD, others in MiFID/MiFIR and PRIIPs.

71 For the retail investor, the EU framework offers a relatively high degree of protection, while inherently reducing the ability of investors to invest in non-EU funds, which often have lower costs.

²⁴ Paragraph 48 of the [EP Resolution of 8 October 2020](#).

72 All the NCAs and asset management associations we surveyed agreed, or strongly agreed, that the EU regulatory framework has been effective in promoting high standards of protection for investors. However, a significant minority of NCAs, including those of some of the main UCITS domiciles, were of the opinion that retail investors in UCITS funds are still not sufficiently protected against the risks of

- insufficient or incorrect disclosure of tax implications (39 %);
- excessive costs and fees (34 %);
- incorrect valuation of assets (26 %);
- insufficient or incorrect disclosure of asset allocation (18 %).

Despite various EU actions, transparency remains an issue

Investors now have access to more information about UCITS

73 The UCITS Directive requires UCITS to issue three reports: a prospectus, an annual report and a half-yearly report²⁵. In its 2019 fitness check of supervisory reporting²⁶, the Commission found that even though the UCITS Directive requires a minimum content for these documents, much remains at the discretion of NCAs. This means that reporting can vary from one Member State to another.

74 The Key Investor Information Document (KIID), which was introduced in 2011, aims to provide retail investors with better disclosure and content that is easier to understand, and to facilitate comparisons between products. The KIID Regulation²⁷ requires it to cover those essential features of the UCITS about which an investor should be informed, and to provide (potential) investors with accurate, fair, clear and non-misleading pre-contractual information.

75 The accuracy and reliability of the information disclosed in the KIID is contested. The Central Bank of Ireland²⁸ found cases where the past performance section of the

²⁵ Articles 68-74 of [Directive 2009/65/EC](#).

²⁶ [SWD\(2019\) 402 final](#).

²⁷ [Commission Regulation \(EU\) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC](#) as regards key investor information.

²⁸ Central Bank of Ireland, '[Thematic review of closet indexing](#)' (industry letter of 18 July 2019).

KIID did not include relevant benchmark disclosure. In 2019, ESMA issued Q&As on benchmark disclosure clarifying these matters.

76 As some ECA survey respondents pointed out, the cost information in the current UCITS KIID is incomplete, and could mislead investors by making them believe that costs are lower than they actually are. In particular, transaction costs are not included in the total expense ratio.

77 The PRIIPs Regulation²⁹, which entered into force in 2018, introduced a uniform Key Information Document (KID) applicable to a wide range of retail investment products. However, UCITS and AIFs were temporarily exempt from this requirement. Following lengthy consultations with stakeholders, the Joint Committee of the ESAs reached a compromise about including past performance in the KID in January 2021, and the Commission adopted a delegation regulation in September 2021.

ESMA has made costs and fees more transparent, but data issues remain

78 Since 2019, ESMA has published an annual report on the performance and costs of EU retail investment products. It aims to alert investors to the significant impact of costs on the final returns on their investments. ESMA's report provides a good overview of the performance and costs of different types of funds, but suffers from a number of weaknesses:

- It reports costs by asset class (equity/bonds/mixed/alternative), by management type (active or passive), and by fund domicile, but not by country of distribution, thus making it difficult to assess whether the single market has reduced cost differences between national markets.
- There is a limited breakdown (e.g. management fees) or none at all (e.g. distribution, inducement) of costs by type. This is related to the lack of granular available data and the reliance on surveys conducted with NCAs, and limits explanations of the reasons why costs are higher in some fund domiciles than in others.
- The report is based on data that are more than a year old, the same is true of ESMA's annual report on AIFs.

²⁹ Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).

79 In its methodological annexes, ESMA points out that “An assessment of the performance and cost of investment products in the remit of ESMA is structurally impeded by the absence of relevant regulatory data:

- UCITS fund data are not accessible at EU level and commercially available data provide a limited level of granularity and accuracy;
- AIFMD regulatory data do not cover granular evidence on fund costs”.

ESMA and the Commission have not yet created comparison tools for retail investors

80 While the focus has been on providing investors with sufficient information about individual funds, it remains difficult to obtain an overview of all funds on offer, and to compare products. The European Parliament³⁰ has called for “initiatives specifically targeting retail investors, including facilitating the development of independent web-based EU comparison tools, to help retail investors determine the most appropriate products in terms of risk, return on investment and value for their particular needs and preferences”.

Greenwashing represents an increasing risk

81 An increasing number of UCITS are being marketed as ESG funds, thus creating the risk of “greenwashing”. The Sustainable Financial Disclosure Regulation applies to investment funds; its objective is to increase transparency and fight greenwashing. As most disclosure obligations only became applicable as of 10 March 2021, it is too early to assess its impact. Building on its [response](#) to the Commission’s consultation on the Renewed Sustainable Finance Strategy, ESMA has recently called for legislative action on ESG ratings and assessment tools³¹.

82 The market for ESG ratings and other assessment tools is currently unregulated and unsupervised. When combined with increasing regulatory demands for consideration of ESG information, there are increased risks of greenwashing, capital misallocation and product mis-selling.

³⁰ [European Parliament resolution of 8 October 2020 on further development of the Capital Markets Union \(CMU\): improving access to capital market finance, in particular by SMEs, and further enabling retail investor participation \(2020/2036\(INI\)\)](#).

³¹ [Letter from ESMA’s Chair Steven Maijoor to Commissioner Mairead McGuinness](#), 28 January 2021, ESMA30-379-423.

ESMA, the Commission and NCAs have helped to introduce a downward trend for UCITS costs

Costs remain high

83 After remaining stable at a high level for many years, UCITS costs have slightly decreased since 2017. However, they remain much higher than for the average US-domiciled fund. This is usually ascribed to the smaller size of funds in the EU (see paragraph [04](#)) and the lower market share of passive funds and ETFs (8.3 %). Amongst others, funds domiciled in Luxembourg and Ireland charge above-average costs³².

84 Actively managed equity funds narrowly outperformed passively managed funds in gross terms, but underperformed on a net basis due to higher costs. Thanks to economies of scale in the management of the funds, ESMA found that larger funds had lower costs. For equity funds, costs were on average 1.4 % for the largest funds and 1.8 % for the smallest funds.

The practice of closet indexing has decreased, but persists

85 An ESMA survey launched in 2019 showed that there remains divergence in the way the notion of “undue costs” is interpreted across the EU and in the supervisory approach to cost-related provisions. According to ESMA³³, this lack of convergence not only leaves room for regulatory arbitrage and risks hampering competition in the EU market, but may also lead to different levels of investor protection, depending on where a fund is domiciled.

86 Closet indexing is a practice whereby asset managers claim to manage their funds in an active manner, the aim being to outperform the benchmark index. However, in reality, they stay very close to a benchmark, which requires less input from the investment manager. They tend to charge higher management fees than passively-managed funds³⁴. Analysis carried out by ESMA five years ago indicated that between 5 % and 15 % of EU equity funds claiming to be actively managed might actually be index trackers (see also [Box 4](#)). More recent 2020 figures indicate that this percentage has decreased to between 2 % and 6 %.

³² [Performance and Costs of EU Retail Investment Products ESMA Annual Statistical Report 2021](#).

³³ ESMA, [Supervisory briefing on the supervision of costs](#), 2020.

³⁴ [ESMA Statement, Supervisory work on potential closet index tracking](#), 2 February 2016, ESMA/2016/165. See also TRV No 1/2021.

Box 4

Closet indexing

In 2018-19, the Central Bank of Ireland carried out a thematic review of closet indexing³⁵, covering all Irish authorised UCITS funds classified as actively managed. Key findings of the review included the following:

- Investors were not always given sufficient or accurate information about the fund's investment strategy in the Prospectus and KIID.
- Instances of poor governance and controls.
- Instances where the fund had a target outperformance against an index that is less than the fee charged, which implies that the fee will cancel out any outperformance achieved.
- In some cases, in the past performance section of the KIID, no comparator was included, meaning that investors in these funds were not able to determine whether the fund represented good value relative to its benchmark.

87 In 2021, ESMA launched a CSA on costs, the aim being to investigate whether fund managers: (1) comply with cost-related disclosure provisions in conducting their business activities with due skill, care and diligence and in the best interests of the fund they manage; (2) act honestly and fairly; and (3) do not charge investors undue costs³⁶. The CSA covers both UCITS and AIFs marketed to retail investors, and is supposed to verify whether managers have pricing policies in place that allow a clear identification and quantification of all costs charged to the fund, and whether policies are correctly applied in practice. The results are expected in early 2022.

The EU has not taken sufficient action against inducements

88 Whether potential investors in funds are well protected and are in a position to choose the investment that best suits their needs depends not only on the requirements imposed on funds and fund managers, but also on the advice they receive from their financial intermediaries.

³⁵ Central Bank of Ireland, 'Thematic review of closet indexing' (industry letter 18 July 2019).

³⁶ ESMA 34-45-970 CSA methodology on costs and fees.

89 Up to a half of the costs are made up of inducements, which are still allowed in most Member States. The legislation³⁷ merely stipulates that inducements should not create a conflict of interest, and need to be disclosed. They should be designed to enhance the quality of the relevant service to the client, and should not impair compliance with the firm's duty to act honestly, fairly and professionally in accordance with its clients' best interests. Some Member States such as the Netherlands have introduced a ban on inducements, which account for about half of the recurrent costs of many UCITS.

90 The Commission pointed out that the distribution model in continental Europe is still largely based on the commission-based remuneration model, with banks and insurers as the most prevalent end-client distributors³⁸. The study also shows that in the countries that have introduced a ban on inducements, the ongoing charges of bond, equity and mixed funds are much lower. As commission is the main driver, passive funds (including ETFs), which rarely pay commission, have traditionally been neglected by banks unwilling to market low-fee products³⁹.

91 In its March 2020 Technical Advice to the Commission⁴⁰, ESMA did not take a clear position on a complete ban on inducements for all MiFID investment services. The consumer organisations we interviewed support such a ban. The Commission is now looking at this issue in the context of its EU strategy for retail investors.

92 In 2017, a private contractor carried out mystery shopping on behalf of the Commission and found that "in each Member State, non-independent advisors at banks and insurance companies almost exclusively proposed (one or a selection of few) in-house products"⁴¹. Most robo-advisors, on the other hand, tend to advise ETFs. A mystery shopping exercise by the French NCA highlighted that products such as ETFs

³⁷ Directive 2014/65/EU on markets in financial instruments.

³⁸ European Commission, *Distribution systems of retail investment products across the EU, final report*, 2018, p. 26.

³⁹ Apostolos Thomadakis, *The European ETF Market: What can be done better?*, ECMI Commentary, No 52, 24 April 2018.

⁴⁰ ESMA's *Technical Advice to the Commission on the impact of the inducements and costs and charges disclosure requirements under MiFID II*, 31 March 2020, ESMA35-43-2126.

⁴¹ European Commission, *Distribution systems of retail investment products across the EU, final report*, 2018, p. 22.

(or other low-cost investment funds) are not proposed to retail investors despite apparently corresponding to their investment needs⁴².

Identification of systemic risks requires further progress

93 Systemic risk is the risk of disruption in the financial system with the potential to create serious negative consequences for the internal market and the wider economy. ESMA is required, in collaboration with the ESRB⁴³, to develop a common approach and criteria for identifying and measuring systemic risk posed by key financial market participants, as well as an adequate stress-testing regime which allows for the evaluation of systemic risk. Financial market participants which pose a systemic risk shall be subject to strengthened supervision.

The assessment and follow-up of systemic risks are at an early stage

94 Neither ESMA nor the ESRB carried out an inventory of existing practices in Member States for monitoring systemic risk. NCAs are, however, represented in the governance of both ESMA and the ESRB, as well as in technical working groups.

95 The Financial Stability Board (FSB)⁴⁴ identified the following systemic risk categories:

- liquidity mismatch between investment fund assets and redemption terms;
- leverage within investment funds;
- operational risk; and
- risks coming from securities lending activities⁴⁵.

⁴² AMF: [Risk and Trend Mapping No 17](#), 2016 Risk Outlook.

⁴³ The ESRB was created in 2009 and given responsibility for the macro-prudential oversight of the financial system within the EU in order to contribute to the prevention or mitigation of systemic risks to financial stability.

⁴⁴ The FSB is an international body that monitors and makes recommendations about the global financial system.

⁴⁵ FSB (12 January 2017): [Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities](#).

96 We found that the first category is covered by ESMA guidelines, and monitoring in the context of the stress simulation exercise (see paragraphs [104-106](#)) has begun. The second category is covered by guidelines for AIFs, whereas the leverage risk for UCITS is limited by the legislative framework. ESMA also developed a draft risk-analysis handbook for NCAs on AIFs. Moreover, the ESRB issued two recommendations addressing elements of the two first risk categories⁴⁶, and concluded that, overall, ESMA is fully compliant with them. The related 2017 ESRB Recommendations (implementation deadline: 31/12/2020) on legislative changes (e.g. liquidity management tools, liquidity mismatches and UCITS reporting) have not yet been addressed by the Commission. The Commission informed us that it would propose the legislative changes as part of the ongoing AIFMD review.

97 There are general provisions on risk management and business continuity in the legislative framework⁴⁷. However, operational risk (including business continuity, transfer of client assets in stressed conditions, and reputational risk), is not covered by up-to-date ESMA guidelines.

98 In 2017, FSB recommended that supervisors should monitor indemnifications provided by agent/lenders to identify risks or regulatory arbitrage that may adversely affect financial stability⁴⁸. Such services are not listed in the AIFMD/UCITS framework.

99 ESMA's risk-assessment work related to investment funds is mainly reflected in four key reports:

- a Risk Dashboard (published twice a year);
- a Trends, Risks and Vulnerabilities (TRV) report;
- an Annual Statistical Report (ASR) on Performance and Costs of EU Retail Investment Products; and
- an Annual Statistical Report on EU Alternative Investment Funds.

⁴⁶ [ESRB/2017/6](#) and [ESRB 2020/4](#).

⁴⁷ Such as Article 57(3) of the AIFMD Level 2 Delegated Regulation (EU) 231/2013 and Article 4(3) of the UCITS Level 2 Commission Directive 2010/43/EU.

⁴⁸ FSB (12 January 2017): [Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities](#), recommendation 14.

100 While ESMA's Risk Dashboard uses a comprehensive set of indicators and provides short and concise analysis, we found that it fails to systematically detail country-related risks which in turn could be used for macro-prudential purposes.

101 We found that the ESRB's non-bank financial intermediation (NBFi) risk monitor provides a good analysis of the investment fund sector by using entity-, activity- and product-based approaches to give a precise breakdown of funds by type. While fund types and assets are detailed by country, risks are not.

102 We found that a more comprehensive view and the reliability of the analysis is limited by the following constraints:

- non-availability/usability of some of the AIF data (see paragraphs [121](#) and [123](#));
- delays in using MMF/difficulties using some of the AIFMD data (see paragraphs [111](#), and [121-122](#)).

There are no supervisory stress tests and, although work has started, simulation follow-up is insufficient

103 Supervisory stress testing should identify those funds posing systemic risk, and recognise patterns for systemic risks to ensure their mitigation⁴⁹. ESMA is authorised, in cooperation with the ESRB, to initiate and coordinate EU-wide stress tests to assess the resilience of financial market participants to adverse market developments.

104 ESMA has not yet run a supervisory stress test for investment funds, but it conducted a stress simulation in 2019 to assess the resilience of the EU fund industry and to identify potential vulnerabilities. The simulation was applied to 6 600 fixed-income UCITS funds covering a total of €2 490 billion NAV⁵⁰. A redemption shock was applied to funds, and the market impact was simulated. Commercial data were used, as ESMA considered NCA data to be too heterogeneous.

105 The stress simulation framework constitutes a good starting point. The current tools, the technical infrastructure and data quality have weaknesses. There was no systematic follow-up of the stress simulation results; they were shared with 11 NCAs on a voluntary basis, but only five opted for a follow-up discussion with ESMA. One

⁴⁹ Article 22(2) and Article 23 of [ESMA Regulation](#).

⁵⁰ [ESMA Economic Report: Stress simulation for investment funds 2019](#).

NCA with a significant fund industry did not wish to have a follow-up discussion with ESMA. In the context of the annual statistical reports, ESMA also sent lists to NCAs on funds which displayed risks, but there was no dedicated follow-up or lessons-learned exercise on the information provided.

106 In May 2020, the ESRB recommended that ESMA should address investment-fund liquidity risk⁵¹. ESMA did this in its November 2020 report, and the stress simulation framework was used in this context. All results were shared with NCAs in December 2020, including the identities of funds which were deemed potentially risky. ESMA staff agreed with IMSC members six months later to report on follow-up actions taken by NCAs, including on the list of potentially risky funds. NCAs had to report back to ESMA in October 2021 with a comprehensive response. Despite this pause, this is a major improvement. Individual names of funds which were deemed potentially risky were not shared with the ESRB.

107 Conceptual work for top-down stress-testing⁵², as well as a comprehensive model which would capture the interconnectedness between the banking, fund and insurance sectors to provide a comprehensive picture of systemic risk, has so far not led to a systematic project plan at ESMA. Such work could also encompass hedge funds and funds which are not supervised in the EU⁵³, but which pose a threat to the financial system.

Internal stress-testing guidelines are appropriate, but stress-test results are not being used effectively

108 A liquidity stress test for investment funds aims to assess their resilience at individual or industry level to redemption shocks. Stress testing can either be conducted by the funds themselves (internal stress testing) or by the supervisor (supervisory stress testing). As regards internal stress-testing, the legal framework is different for AIFs, UCITS and MMFs. [Figure 9](#) shows the links between fund types, legislation and related guidelines.

⁵¹ [Recommendation of the ESRB on liquidity risk in investment funds \(ESRB/2020/4\)](#).

⁵² E.g. Gourdel, Maqui and Sydow (2019): [Investment funds under stress, ECB Working Paper 2323](#).

⁵³ Funds not supervised in the EU can constitute major asset classes for investors, including financial institutions.

Figure 9 – Stress-testing regimes for AIFs, MMFs and UCITS

FUND TYPE	<div><div></div><div>Alternative investment funds (AIFs) <i>Articles 15, 16, 24, 25 AIFMD</i><ul style="list-style-type: none">Funds to report results of internal stress tests to NCAsNCAs should consider built-up of systemic risk using information reported on under Article 24Sharing of related information with EU NCAs, ESMA and ESRB (supervisory cooperation)ESMA may determine that an AIF that poses risks to financial stability and may issue advice to NCA</div></div>	<div><div></div><div>Undertakings for Collective Investment in Transferable Securities (UCITs) <i>Article 51 UCITS-D; Article 40 (3) Implementing provision</i><ul style="list-style-type: none">High-level provisions for risk managementNo specific mentioning of stress testing</div></div>	<div><div></div><div>Money Market Funds (MMF) <i>Article 28, 37 MMFR, Implementing Regulation 2018/708 of 17 April 2018</i><ul style="list-style-type: none">Requirement to conduct regular stress tests at fund level at least bi-annuallyWhen vulnerabilities of the MMF prepare and sent report to NCAReporting under Article 37 MMFR: Sent annual/quarterly results to NCAs</div></div>	
GUIDELINES	<div><div></div><div>Guidelines on Article 25 of the AIFMD<ul style="list-style-type: none">Identification of AIFs more likely to pose risks to the financial system by fund managersEvaluation of related risks by fund managersReporting to the NCA</div></div>	<div><div></div><div>Guidelines on liquidity stress-testing in AIFs and UCITS (16 July 2020)<ul style="list-style-type: none">Design of LST models, understanding of risks, governanceFrequency, policies, scenarios, dataInteraction with NCA</div></div>	<div><div></div><div>Guideline on the reporting to competent authorities under Article 37 of the MMF regulation<ul style="list-style-type: none">Detailed description what should be reported (data fields), also includes stress-test information</div></div>	<div><div></div><div>Guidelines on stress test scenario under the MMF regulation 2019 and 2020 (19/7/19 and 16/12/20)<ul style="list-style-type: none">General guidelines internal stress testing and a scenario for stress-testing (parameters)</div></div>
REPORTING	<div><div></div><div>Reporting to NCA systematic, sharing with ESMA rather unsystematic</div></div>	<div><div></div><div>Reporting to NCA not systematic, no ESMA involvement</div></div>	<div><div></div><div>Regular reporting to NCA, ESMA received the first reports under Article 37 only June 2021</div></div>	

Source: ECA.

109 We found that ESMA developed appropriate guidelines regarding internal stress tests both for UCITS and AIFs. However, the level of scrutiny of internal stress-test results – if any – is entirely at the discretion of NCAs, and ESMA does not have any information in this respect. Moreover, UCITS perform internal stress-testing, and have to report to their NCAs only in the event of material risks; the NCAs would then have to inform ESMA. However, this has not yet occurred. Although ESMA has access to AIF stress-test results, the underlying methodology is at the discretion of the fund manager, and so ESMA has not compared or used the results.

110 For MMFs, the MMFR stipulates that ESMA has to publish guidelines with common stress-test reference parameters. In this context, ESMA defined a strong

redemption shock (a redemption rate of 30-40 %) but followed the ESRB's calibration of parameters (e.g. interest rates and foreign exchange rates), rather than setting the severity for these parameters itself. ESMA did not ask for an *ex ante* sensitivity analyses for the parameters to obtain a better understanding of the risk drivers. However, ESMA is performing *ex post* analyses of the parameter impact after receiving results.

111 Given the legal framework, except for MMFs, UCITS stress-testing data are not systematically aggregated, analysed or reported. Such data could be used to develop supervisory stress testing or back-testing results of stress simulations. For MMFs, the reported data were received very late, and ESMA only started analysing Q1 2020 data – received in mid-2021 – towards the end of that year.

Gaps and overlaps in data collection hamper the identification of risks to financial stability and investors

112 Effective monitoring of systemic risks and risks to investors depends on the availability of suitable data. Data must be sufficiently granular, of good quality and comparable across countries so that meaningful risk-analyses can be performed. In order to be efficient, data collection should not create unnecessary burdens on the industry, and should meet the data needs of all authorities who require access to the information in order to fulfil their mandates.

113 The UCITS Directive, the AIFM Directive and the MMF Regulation each require funds or fund managers to report data to NCAs. However, the type of data, and the format and level of detail that need to be reported, vary by type of investment fund, and NCAs are not always required to share the data with ESMA or the ESRB. The requirements reflect the level of risk emanating from the respective fund, but also the age of the respective piece of legislation. The MMF reporting regime is more extensive than the regime established by the AIFM Directive and the UCITS Directive. It is based on granular data using international identifiers.

The lack of a harmonised reporting regime for UCITS impedes ESMA's ability to assess the crisis-preparedness of funds and conduct stress tests

114 The AIFM Directive specifies reporting obligations that AIFMs must fulfil vis-à-vis their home NCA. This includes the requirement to provide details of the funds that a particular AIFM manages, including investment strategies, as well as the most

important markets, net asset values and the portfolio liquidity profile⁵⁴. NCAs are required to share these data with ESMA on a regular basis (see [Annex](#))⁵⁵.

115 By contrast, there is currently no harmonised reporting framework on UCITS at EU level. While the UCITS Directive sets out the minimum content for some key documents that each UCITS must issue, other details of reporting remain at the discretion of NCAs. As a result, reporting practices differ widely between NCAs in terms of reporting frequency, the UCITS covered, and the data reported⁵⁶. The data that are generated are not comparable.

116 The lack of detailed reporting requirements on UCITS made it difficult for ESMA to perform the analyses needed to assess the crisis-preparedness of investment funds with significant exposures to corporate debt and real estate in the context of the COVID-19 crisis⁵⁷. It has also impeded ESMA's ability to run stress simulations and perform supervisory stress tests.

117 Moreover, the UCITS Directive does not explicitly require NCAs to share data collected for supervisory purposes with ESMA, but ESMA can request information to fulfil its duties⁵⁸. If the NCA cannot adequately meet its request, ESMA can approach other national authorities, including national central banks and statistical offices, or directly approach market participants. According to ESMA, such data requests still require approval from the Board of Supervisors, and are therefore made only on an exceptional basis.

118 The results of an ESMA survey of 10 NCAs in 2021 show that although most NCAs collect data on UCITS and UCITS management companies, the reporting regimes differ substantially. Due to a lack of direct access and consistency in reporting, ESMA has so far not asked them to report such data.

119 ESMA and the ESRB therefore rely on other, mainly commercial, sources of data for reporting and analysis of UCITS (see [Annex](#)). According to ESMA and the

⁵⁴ AIFMD, Article 24.

⁵⁵ AIFMD, Article 25(2).

⁵⁶ ESRB/2017/6.

⁵⁷ ESRB/2020/4.

⁵⁸ Regulation (EU) No 1095/2010, Article 35.

stakeholders we spoke to, although funds frequently report to commercial providers, relying on commercial data raises challenges related to completeness and data quality.

120 The ESRB recommended in 2017 that EU legislators should initiate a harmonised reporting regime for UCITS⁵⁹. However, this recommendation has not been acted upon. A majority of the NCAs and asset-management associations we surveyed agreed, or strongly agreed, that the regulatory framework for investment funds would benefit from improved reporting requirements. They suggest that a future UCITS reporting regime could be aligned with the AIFMD reporting regime, taking into account the differences between the two types of investment funds.

Some essential reporting requirements are not mandatory in the AIFM Directive

121 Although the AIFMD includes a harmonised reporting regime, its usefulness is hampered by the fact that it does not oblige fund managers to report some key data. In particular, while the AIFM Directive and Commission Delegated Regulation (EU) No 231/2013 require AIFMs to provide legal entity identifier (LEI) codes to identify themselves and the funds they manage, reporting of LEIs at further levels of detail (e.g. prime brokers of AIFs) is left optional. The guidance also requires AIFMs to provide the international securities identification number (ISIN) codes and other international codes the AIF may have, but only if available.

122 The current arrangement has resulted in a low percentage of AIFMs and AIFs actually reporting common identifiers such as LEIs and ISINs. By contrast, LEI coverage for funds with derivative exposures is above average. This is because unlike the AIFM Directive, EMIR directly requires counterparties to report global entity identifiers and ISINs. Higher LEI and ISIN coverage would allow ESMA and the ESRB to connect various data on AIFMs and AIFs more effectively, and to identify systemic risks⁶⁰.

⁵⁹ [ESRB/2017/6](#), Recommendation D.

⁶⁰ [ESRB, The benefits of the Legal Entity Identifier for monitoring systemic risk](#), Occasional Paper Series No 18 (September 2021).

National Central Banks collect data for statistical reporting, but this is not available to ESMA or the ESRB

123 ESMA does not currently have fund portfolio data for UCITS and AIFs. However, data at that level would be needed in order to conduct meaningful risk analyses and supervisory stress-testing on the basis of regulatory rather than commercial data.

124 National central banks (NCBs) are already required to collect granular data on investment funds – including AIFs and UCITS, but not MMFs – in a uniform manner for ECB statistical reporting⁶¹. The data include fund details at ISIN level. However, NCBs only make these data available to the ECB in an aggregated manner, as the confidentiality regime established by the Council in 1998 largely restricts the use of the confidential data collected by NCBs “for the exercise of the tasks of the ESCB”⁶². Some of the aggregated data collected by the ECB are already made accessible to ESMA and the ESRB, but they are not granular enough to allow proper monitoring of systemic risk.

125 ESMA and the ESRB have not fully explored possibilities for accessing and using the more granular portfolio-level data that NCBs collect (see paragraph [117](#)), citing legal and operational challenges. We note that, in certain cases, NCBs are also the authorities responsible for supervising investment funds.

⁶¹ Regulation ECB/2013/38.

⁶² Council Regulation (EC) No 2533/98, Article 8(5).

Conclusions and recommendations

126 Our overall conclusion is that although EU actions have enabled a single market for investment funds to be established, they have not yet achieved the desired outcomes, as true cross-border activities and benefits for investors remain limited. In addition, the consistency and effectiveness of fund supervision and investor protection is insufficient.

127 The Commission and EU co-legislators set ambitious objectives for a single market for investment funds, namely to enable the efficient distribution of funds in other Member States, to ensure effective and similar protection of investors, and to create a level playing field for competitiveness (see paragraphs 16-17). We conclude that the Commission and the co-legislators have enabled cross-border business through the “passporting” regime, but have only been effective to a limited extent in increasing the number of true cross-border funds (i.e. those marketed in several Member States), which was a key objective. Their number has grown only marginally (see paragraphs 18-21).

128 We found that the expected gains for investors, such as lower fees through competition and innovation, or access to more products, have not materialised. Costs continue to be high, and differ significantly from one Member State to another (see paragraph 83). Furthermore, there is still no level playing field, as supervisory practices and outcomes vary significantly between Member States, and market entry barriers persist (see paragraphs 22-23). We note that certain market realities and policy choices, such as taxation, local demand and instances where asset managers choose to distribute their investment funds, cannot be addressed by EU law.

129 While the initial setup of the EU legal framework was a step forward, subsequent repeated revisions have not led to different outcomes, and may not be the appropriate tool to deepen the single market. The Commission has not carried out a comprehensive fitness check of the overall legal framework covering investment funds in order to assess to what extent the various objectives have been achieved. We conclude that the Commission was not always in a position to demonstrate the merits or the effectiveness of its legislative initiatives to enhance the existing rules. *Ex ante* impact assessments may have overestimated the potential impacts of new legislation, and *ex post* evaluations need to be more thorough (see paragraphs 26-30). Lastly, the Commission’s performance measurement does not comply with its own criteria (see paragraph 31).

Recommendation 1 – Assess the suitability of the existing framework to achieve the desired objectives

The Commission should:

- (a) carry out a comprehensive fitness check on the legislation covering investment funds; and, depending on its outcome, take measures to achieve the objectives of the single market more effectively;
- (b) improve its performance measurement by establishing appropriate indicators.

Timeframe: by 2024

130 ESMA has stepped up its efforts in the area of supervisory convergence. For instance, it created a framework for identifying and focusing on key supervisory risks (see paragraphs [40-41](#)). However, it faces challenges in using its tools effectively, such as its own governance structure and its dependency on NCA cooperation. NCAs have a clear preference for convergence tools that are “non-invasive” (see paragraphs [56-57](#)).

131 ESMA has mainly used preparatory tools such as guidelines and Q&As. We found that the effectiveness of these tools is not demonstrated as ESMA doesn’t measure the effect of all its convergence actions (see paragraphs [42-43](#)). ESMA has recently established new tools, and uses them for priority areas. It focused more on tools like CSAs, which create a space for participating NCAs to share and discuss practices (see paragraphs [44-46](#)). However, ESMA has rarely used its policing role (see paragraphs [42-48](#)).

132 As a result, ESMA’s efforts only had a limited effect in creating consistent and similar supervision. We did find cases where ESMA’s work enhanced the quality of national supervision and reduced differing practices. ESMA is not in a position to demonstrate its progress yet, as it does not measure its achievement of objectives (see paragraphs [58-60](#)). ESMA’s work has also revealed some weaknesses in supervision at national level, in particular where enforcement is concerned (see paragraphs [61-68](#)).

Recommendation 2 – Enhance the effectiveness of ESMA’s convergence work

The Commission should:

- (a) consider proposing changes to ESMA’s governance structure, which would allow ESMA to use its powers more effectively, including making NCAs' participation in ESMA's convergence work compulsory and giving the operational lead to ESMA staff.

ESMA should:

- (b) introduce a more structured approach to selecting convergence tools, strengthen follow-up, and use remediation tools including ‘breach of Union law’ procedures when necessary;
- (c) enhance its capacity to monitor progress by mapping supervisory practices, assessing the effectiveness of tools, and overhauling its performance measurement.

Timeframe: by 2024

133 The Commission and ESMA have increased the transparency of investment funds, and of their risks and costs. Key tools were the introduction of a Key Investor Information Document and the publication of an annual report on performance and costs. However, weaknesses in the information provided to investors still exist, and it remains very difficult for investors to compare funds (see paragraphs [73-80](#)).

134 Costs for investors have slowly decreased over the last few years, but investors are still not sufficiently protected against undue costs charged by fund managers (e.g. through closet indexing), or against biased advice from financial intermediaries, who continue to receive inducements in most Member States (see paragraphs [83-92](#)). Furthermore, Environmental Social Governance ratings are largely unregulated and unsupervised (see paragraphs [81-82](#)).

Recommendation 3 – Protect investors better against undue costs and misleading information

The Commission should:

- (a) better protect retail investors, in particular through stricter rules on inducements

ESMA should:

- (b) further refine its analysis of the performance and costs of retail investment products, especially by country of distribution and type of cost; and
- (c) develop a tool allowing investors to obtain information about all funds on offer that respond to certain criteria, and to compare the costs and performance of those funds.

Timeframe: by 2024

135 ESMA monitors systemic risk through regular and ad hoc external and internal reporting, but risks are not broken down by country. No formal inventory has been drawn up of existing practices in Member States for monitoring systemic risk (see paragraphs 94, and 99-102). The Financial Stability Board identified risks posed by asset-management activities. ESMA has addressed the two main risks: leverage and liquidity, while general type provisions are in the legislation we found that operational risk is not covered by up to date ESMA guidelines (see paragraphs 95-98).

136 ESMA did not run supervisory stress-tests, even though these were envisaged in its founding regulation. It only ran stress simulations based on market data, and only now are results starting to be followed up, albeit slowly. Conceptual work for supervisory stress-testing has not started. We found that ESMA developed appropriate guidelines for internal stress tests. Except for Money Market Funds stress-testing data are not systematically reported. Reported data have not yet been used to develop supervisory stress-tests or back-test results of stress simulations (see paragraphs 103-111).

Recommendation 4 – Improve the identification of systemic risk

ESMA should, in cooperation with the ESRB define for which fund types supervisory stress testing is necessary; explore how the results of existing stress tests and simulations can be used more effectively and develop a comprehensive model which allows for analysis of interconnectedness.

Timeframe: by 2025

137 There is currently no harmonised reporting regime for Undertakings for Collective Investment in Transferable Securities at EU level. As a result, supervisory data collected by NCAs in Member States are not comparable. Reporting on Alternative Investment Funds is harmonised at EU level, but the reporting framework does not oblige their managers to report common identifiers and portfolio-level details. Insufficient data quality, availability and use adversely affect the monitoring of risk and the performance of related stress-tests (see paragraphs [112-122](#), and paragraph [102](#)).

138 National central banks are already collecting granular portfolio-level information on Undertakings for Collective Investment in Transferable Securities and Alternative Investment Funds for statistical reporting purposes. However, they only provide these data on an aggregated basis to the ECB, which shares a subset of this information with ESMA and the ESRB. While their respective founding regulations empower them to request information on an ad hoc basis, they have not used this power to obtain the existing data. In general, such requests require approval by their boards, and may not be suitable for monitoring systemic risks on a regular basis (see paragraphs [117](#), and [124-125](#)).

Recommendation 5 – Streamline data collection and update reporting regimes

The Commission should:

- (a) support ESMA and the ESRB in accessing needed information on funds that is available to NCAs and Eurosystem Central Banks and propose a harmonised reporting regime on UCITS;
- (b) assess what additional data on funds is needed and how it should be collected to better monitor risks, keeping reporting burdens on the industry to a minimum.

Timeframe: by 2024

This Report was adopted by Chamber IV, headed by Mr Mihails KOZLOVS, Member of the Court of Auditors, in Luxembourg on 18 January 2022.

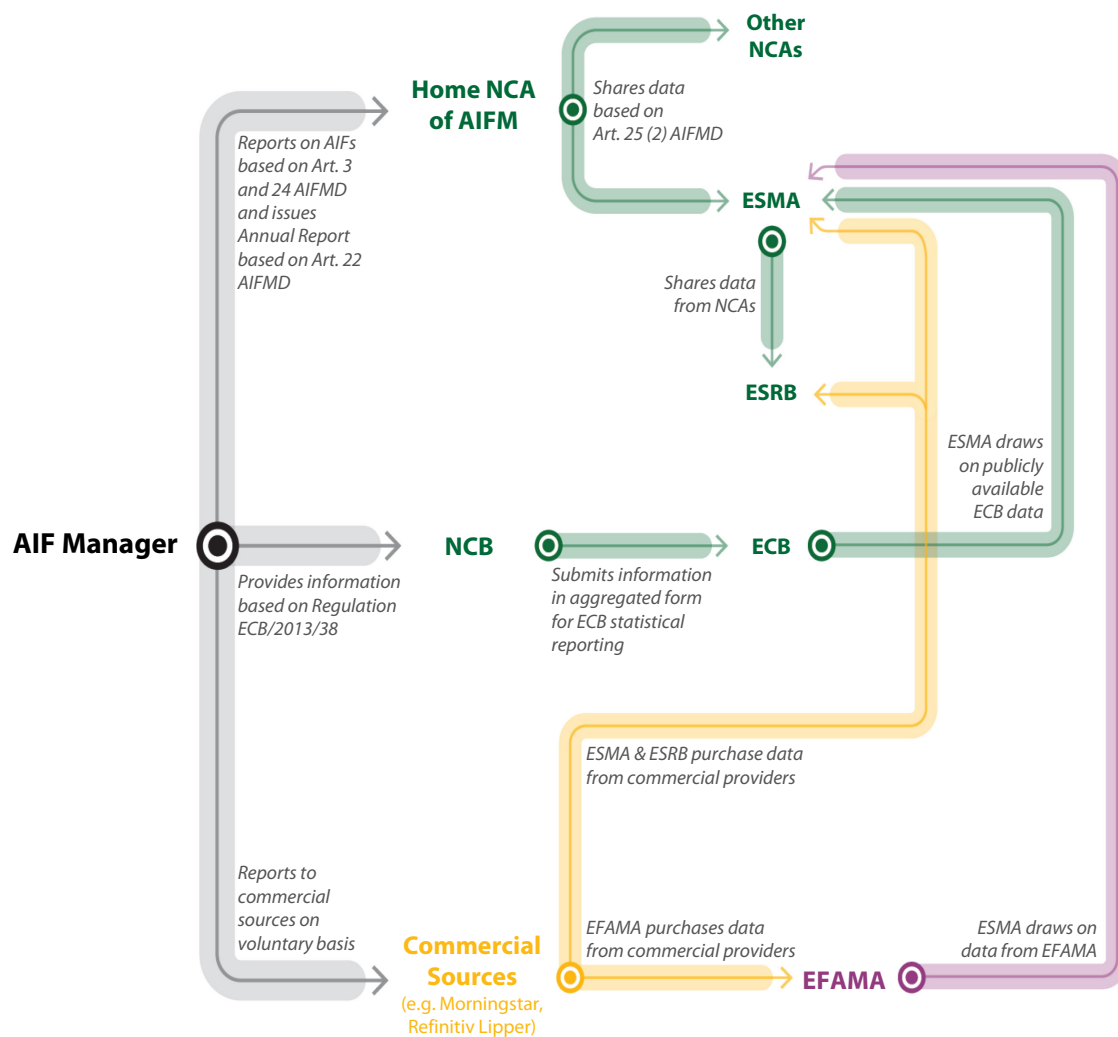
For the Court of Auditors

Klaus-Heiner Lehne
President

Annex

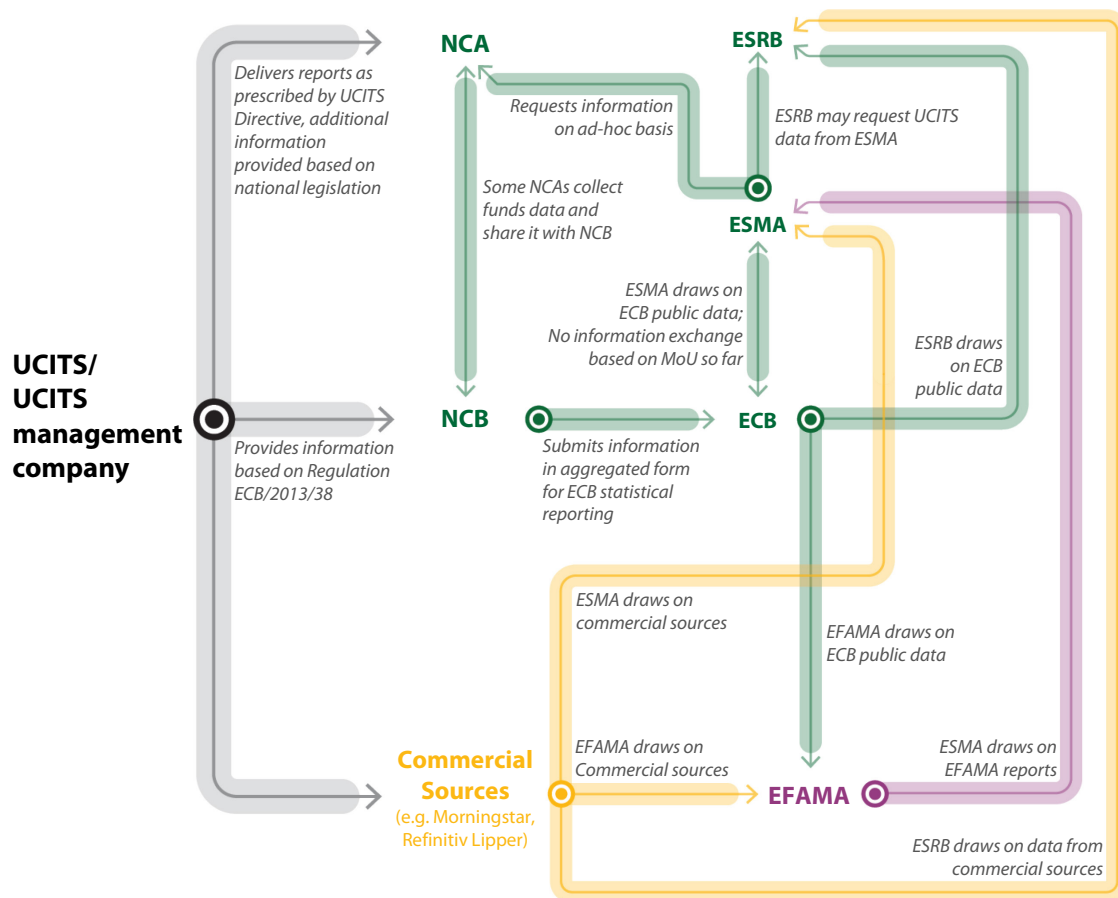
Annex – AIF and UCITS data collection and sharing of information

AIF data collection and sharing of information



Source: ECA.

UCITS data-collection and sharing of information



Source: ECA.

Acronyms and abbreviations

AIF: Alternative Investment Fund

AIFM: Alternative Investment Fund Managers

AIFMD: Alternative Investment Fund Managers Directive

AMF: Autorité des marchés financiers

AWP: Annual Work Programme

CA: Competent authority

CMU: Capital Markets Union

CSA: Common supervisory action

EBA: European Banking Authority

ECA: European Court of Auditors

ECB: European Central Bank

EFAMA: European Fund and Asset Management Association

EIOPA: European Insurance and Occupational Pensions Authority

EMIR: European market infrastructure regulation

ESA: European Supervisory Authority

ESG: Environmental, Social and Governance

ESMA: European Securities and Markets Authority

ESRB: European Systemic Risk Board

ETF: Exchange-Traded Fund

FSB: Financial Stability Board

FTE: Full-time equivalent

IF: Investment Fund

IMF: International Monetary Fund

IOSCO: International Organization of Securities Commissions

ISIN: International securities identification number

KID: Key Information Document (under PRIIPS)

KIID: Key Investor Information Document (under UCITS)

LEI: Legal Entity Identifier

MiFID (I / II): Markets in Financial Instruments [Directive](#)

MiFIR: Markets in Financial Instruments Regulation

MMF(R): Money Market Fund (Regulation)

NAV: Net Asset Value

NCA: National Competent Authority

NCB: National central bank

PRIIPs: Packaged Retail Investment and Insurance-based Products

TFEU: Treaty on the Functioning of the European Union

TRV: Trends, risks and vulnerabilities

UCITS: Undertakings for Collective Investment in Transferable Securities

UCITS Directive

Glossary

Alternative Investment Fund (AIF): All investment funds that are not covered by the EU Directive on UCITS, and instead fall under the Alternative Investment Fund Manager Directive (AIFMD). This includes hedge funds, venture capital, private equity funds and real estate funds.

Conformity check: A check that the relevant provisions of an EU directive have been accurately reflected in national implementing measures.

Delegation arrangements: Arrangements where certain functions are not performed by the authorised entity itself, and are therefore subject to delegation monitoring. The use of delegation arrangements may be an efficient way to perform some functions or activities. However, such arrangements are not without risks, and must be subject to appropriate oversight.

European Banking Authority (EBA): An EU regulatory agency that works to ensure effective and consistent prudential regulation and supervision across the European banking sector. Its tasks include initiating and coordinating stress tests for the EU financial sector; it also sets relevant standards.

European Securities and Markets Authority (ESMA): An EU regulatory agency that contributes to safeguarding the stability of the EU's financial system by enhancing the protection of investors and promoting stable and orderly financial markets. Its tasks include fostering supervisory convergence among Member States' national competent authorities with responsibility for securities and capital markets supervision.

European Supervisory Authorities (ESAs): The collective term for the three bodies responsible for oversight of the financial sector: the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

Exchange-traded fund (ETF): is a type of security that tracks an [index](#), sector, commodity, or other asset, but which can be purchased or sold on a stock exchange.

Financial intermediary: An entity acting as a link between the fund manager of a financial instrument and the final recipients.

Fitness check: An evaluation to identify any overlaps, gaps, inconsistencies or obsolete measures in the regulatory framework for a policy area.

Fund manager: A body or person responsible for implementing an investment strategy and managing a portfolio of investments relating to a financial instrument.

Greenwashing: is the process of conveying a false impression or providing misleading information about how a company's products are more environmentally sound.

Hedge fund: A type of AIF seeking to make a positive return by using more flexible investment strategies, often by using leverage (in other words, borrowing to increase investment exposure as well as risk), short-selling and other speculative investment practices that are not often used by other types of funds.

Impact assessment: An analysis of the likely (*ex ante*) or actual (*ex post*) effects of a policy initiative or other course of action.

Inducements: Payments made to a third party for the provision of services.

Infringement procedure: A procedure whereby the Commission takes action against an EU Member State that fails to meet its obligations under EU law.

IOSCO Principles: Principles set up by the International Organisation of Securities Commission (IOSCO). They are based upon three objectives of securities regulation: protecting investors; ensuring that markets are fair, efficient and transparent; and reducing systemic risks.

Key performance indicator: A quantifiable measure showing performance against key objectives.

Management passport: Allows a UCITS management company or AIF manager (AIFM) which has been authorised in a Member State to carry out its business in other EU Member States, either under the freedom to provide services or by establishing a branch. While such cross-border activity is subject to a notification procedure between the NCAs in the Member States involved, the fund manager does not have to undergo a further authorisation process.

Marketing passport: Allows UCITS or AIFs which have been authorised by the NCA in an EU Member State to be marketed in other EU Member States on a cross-border basis without the need for authorisation by the NCAs of the host Member State. While the UCITS marketing passport allows the marketing of UCITS to retail and institutional investors, the AIF marketing passport is limited to marketing to professional investors only. Similar to the management passport, authorisation is replaced by a notification procedure between NCAs in different EU Member States.

Markets in Financial Instruments Directive (MiFID): The EU legal framework regulating financial markets and improving investor protection. MiFID II replaced the original Directive in 2018.

Money market fund (MMF): funds investing in short-term debt.

Mystery shopping: an undercover research approach used by NCAs, or market research companies that they may have used, to measure quality of customer service and/or gather information about financial products and services and the conduct of financial intermediaries towards consumers.

National competent authority: A national body responsible for banking and/or securities market supervision.

Redemption: exchanging funds for cash.

Single rulebook: set of legislative texts that all financial institutions in the EU must comply with.

Stress testing: A simulation to assess a financial institution's ability to withstand different crisis scenarios.

Supervisory convergence: Supervisory convergence of supervisory practices and outcomes describes the process of promoting the consistent and effective implementation and application of harmonised but not uniform rules by NCAs across the EU. Convergence does not mean a one-size-fits-all approach. The overall goal is to strive for comparable regulatory and supervisory outcomes.

Supervisory stress test: A stress test conducted by the supervisory authority.

Systemic risk: The risk of disruption in the financial system with the potential to create serious negative consequences for the internal market and the wider economy.

Transposition of EU law: The procedure by which EU Member States incorporate EU directives into their national law in order to make their objectives, requirements and deadlines directly applicable.

True cross-border fund: fund marketed in at least 3 resp. 5 countries.

Undertakings for Collective Investment in Transferable Securities (UCITS): An investment vehicle that pools investors' capital and invests it collectively through a portfolio of financial instruments such as stocks, bonds and other securities. UCITS, which are covered by an EU Directive, can be distributed publicly to retail investors across the EU based on a single authorisation from one Member State.

Replies of the Commission and ESMA

<https://www.eca.europa.eu/en/Pages/DocItem.aspx?did=60837>

Timeline

<https://www.eca.europa.eu/en/Pages/DocItem.aspx?did=60837>

Audit team

The ECA's special reports set out the results of its audits of EU policies and programmes, or of management-related topics from specific budgetary areas. The ECA selects and designs these audit tasks to be of maximum impact by considering the risks to performance or compliance, the level of income or spending involved, forthcoming developments and political and public interest.

This performance audit was carried out by Audit Chamber IV Regulation of markets and competitive economy, headed by ECA Member Mihails Kozlovs. The audit was led by ECA Member Rimantas Šadžius, supported by Mindaugas Pakštys, Head of Private Office and Matthias Blaas, Private Office Attaché; Ioanna Metaxopoulou, Director; Paul Stafford, Principal Manager; Eddy Struyvelt, Head of Task; Jörg Genner, Mirko Gottmann, Helmut Kern, Anna Ludwikowska and Nadiya Sultan, Auditors. Mark Smith provided linguistic support.



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Investment funds play a key role in the European capital markets union, helping investors to allocate their capital efficiently. We assessed the suitability of the regulatory framework, the EU's efforts to create similar and effective supervision in all Member States as well as its investor protection and financial stability work.

We found that EU actions have enabled a single market for investment funds, but have not yet achieved the desired outcomes, as true cross-border activities and benefits for investors remain limited. The consistency and effectiveness of fund supervision and investor protection is insufficient. We recommend an overhaul of the legal framework, more effective convergence work, better investor protection and a streamlined reporting framework.

ECA special report pursuant to Article 287(4), second subparagraph, TFEU.



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