

EPFSF Briefing: Investment Funds and Asset Management

Summary

The European Commission published in July 2005 a Green Paper on Enhancing the European Framework for Investment Funds (COM (2005) 314 final). The Green Paper examines the existing European legislation, questioning areas where the legislative framework may be further developed to deal with some of the main structural challenges confronting the EU fund industry. The European Parliament's ECON Committee is currently examining a draft Report (rapporteur Wolf Klinz, ALDE D), which was the topic of a recent committee public hearing. Based on the discussions to date, the vast majority of stakeholders, including the European Commission and the European Parliament, does not believe that there is a need for an overhaul of EU legislation at the current time. Instead, the debate has split into two parts: firstly, the short-term debate focusing more on the implementation of UCITS III and the improvement of certain provisions of the directive and secondly the long-term challenges of creating a genuine European internal market.

The Commission is due to publish a White Paper in October 2006.

Background

In the field of asset management it is crucial to distinguish between harmonised funds – labelled as UCITS (Undertakings for Collective Investment in Transferable Securities) – which have to comply with the relevant EU laws and regulations and enjoy the European passport, and non-harmonised collective investment schemes – such as hedge funds and private equity funds.

70% of the €5 trillion of assets managed by the European fund industry is in the form of UCITS; there are almost 29,000 UCITS funds in the EU; 16.1% of the total number of UCITS are truly sold on a cross-border basis (source: European Commission, 2005). UCITS is not only an important EU label but is increasingly recognised as an international brand beyond the EU borders (e.g. South East Asia and South America),

The EU legislative framework with respect to UCITS is made up of the binding UCITS Directives¹ on one side, and of the non-binding European Commission Recommendations on the use of derivatives (2004/383/CE), the simplified prospectus (2004/384/CE) and the recent CESR Advice on eligible assets (CESR/06-005) on the other side. Moreover, CESR has conducted a review on the implementation of the Commission's Recommendations and is currently drafting the guidelines on the notification procedure for the distribution of UCITS in host Member States.

However, the UCITS Directives have been interpreted differently by different Member States and different rules have been enacted to govern distribution channels, marketing activities and additional local documentary requirements. This constitutes a barrier to an efficient passporting regime, given the cost and resources to be utilised in analysing and assessing different marketing and distribution regimes in different Member States.

Issues at stake and possible evolution

- Investor protection: The simplified prospectus is the main tool to inform final investors about a UCITS and to enable them to make an informed decision. There is common agreement that the current format does not provide investors with clear, concise and comparable information. A widely accepted solution could be the replacement of the simplified prospectus with a simpler and shorter fact sheet, identical in all Member States. The information to be included and the length of the fact sheet are currently under scrutiny. Furthermore, it is necessary that the total expense ratio (TER) is calculated uniformly and the overall cost and performance structure, interpretation and representation are comparable in all Member States.

¹ Directive 85/611/EEC as integrated and amended by Directive 88/220/EEC, Directive 95/26/EC, Directive 2000/64/EC, Directive 2001/107/EC and Directive 2001/108/EC.

The debate also tackles the level of financial risks to be embedded into a UCITS and therefore the risk attitude of retail investors, for whom UCITS are primarily designed. Distributors tend to be more conservative in the interpretation of the average retail investors' attitude, thus sticking to the original concept that UCITS should be non-complex and non-speculative financial instruments. On the opposite, asset management companies are more progressive and hence suggest that UCITS should be allowed to cover a range from the non-complex to the more complex and that the distributor should be able to advise customers and recommend the most appropriate investment vehicle based on the relevant investor's experience and level of sophistication.

- European passport: According to the UCITS Directives, both the UCITS funds and the UCITS asset management companies should benefit from the European passport. However, as a matter of fact, the functioning of the fund passport is hampered by the notification procedure, which *de facto* has often become a licensing procedure. While, in this respect CESR's initiative to draft guidelines to speed up and simplify the notification procedure in accordance with the spirit of the UCITS Directive is broadly welcome, the first draft of the above guidelines has been considered less than satisfactory by most of the industry; asset managers have manifested their disappointment through various associations (see for example the IMA's and EFAMA's response to the CESR's guidelines). The asset management companies underline that their passport is theoretically possible only in Italy and the UK and advocate a consistent and effective implementation of the Directive.

There is discussion as to whether a European depositaries' passport would serve a useful purpose. Although some big financial intermediaries stress the sizeable economies of scale of such passport, the rest of the industry, as well as Supervisors and the ECB, are more cautious and question the need for this at the moment.

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- Cross-border consolidation: It is a shared view that European UCITS funds are on average a sub-optimal size and therefore that some consolidation is needed, in order to bring efficiency (e.g. lower costs and higher performance) to both the industry and the investors. At the moment there are several concurrent solutions brought forward by the various stakeholders, such as the use of delegation arrangements, of pooling, and also of master-feeder structures. The distinction between virtual pooling and master-feeder funds lies in the ownership of the assets under management. In the first case each participating fund maintains the ownership of such assets; on the opposite, in the second case feeder funds simply own units of the master fund and hence do not have any proprietary right on the managed assets, which in turn are owned and managed exclusively by the master fund. A third intermediate type of pooling are the so-called "transparent master-feeder structures", whereby the underlying portfolio is owned by all participating funds and is managed by a partnership.

As a tendency big players, coming from "exporting" countries, support the master-feeder structures, whereas mid-size firms tend to be more in favour of virtual pooling. Supervisors point out that only upon a clear division of responsibilities among competent authorities it is possible to envisage master-feeder and pooling structures.

- Distribution structure: From a legal perspective, there are some major coordination issues between the product-based UCITS Directive and the subject-based MiFID as to the conduct of business rules applying to the provision of UCITS investment services, also in view of the optional exemption under Article 3 MiFID. Another legal issue under scrutiny is the level of competition among distributors; part of the industry has called for a sector enquiry by DG COMP. There is concern amongst asset managers that distribution costs in the EU are too high and that there could be greater open architecture. On the other hand, distributors argue that costs and fees are fully disclosed to investors, that there is more and more choice and that the open architecture model is

increasingly spreading. It is expected that the Commission will set out its view on the necessity of a directive on distribution in the forthcoming White Paper.

- Investment policy: Having collected the comments from almost 50 responding market participants during two rounds of consultations, CESR published its final advice to the European Commission on the eligible assets of UCITS on January 26th 2006. CESR's advice focuses on the clarification of definitions concerning eligible assets for investments of UCITS. The following three key issues were raised:

- o The negotiability of transferable securities: It has been clarified that where a security is listed, a presumption of negotiability applies, but as with the presumption of liquidity, it is not guaranteed.
- o The eligibility of money market instruments: CESR's advice makes a distinction between different types of issuers, and the information requirements have been relaxed for certain types of issuers / issues, e.g. when the issuer is an establishment subject to prudential supervision.
- o The eligibility of derivative instruments on financial indices: In CESR's view, in addition to indices based on financial derivatives on commodities, as suggested in the 2nd consultation, indices on property may be eligible, provided they comply with the criteria developed, e.g. that the index is sufficiently diversified and represents an adequate benchmark for the market to which it refers. Given the complexities of hedge fund indices and the fact that they are still developing, CESR at this stage does not recommend allowing hedge fund indices to be considered as financial indices for the eligibility of UCITS.

- Non-UCITS investments: There is a number of investment products (e.g. hedge funds, private equity funds and real estate funds) which are becoming more and more popular both amongst institutions (who demand investment flexibility beyond that permissible in UCITS) and among retail investors. Such funds fall outside the scope of any EU legislation. Two connected but distinct issues arise from this. First, the current inability to promote such structures to institutional investors without local registration (which in some cases is not possible) is widely thought to be unwarranted restriction in the development of the European single market and a simple pan-European private placement regime to such investors, along the lines of that created under the Prospectus Directive would seem to be a fair and pragmatic step in the wholesale market. Second, is the equally important but distinct issue of whether such products should be available to retail investors. While there is a view on the part of a number of regulators that domestic regulation of these financial instruments is appropriate and calls for a minimum "light-UCITS" harmonisation for these products, others as well as a substantial part of the industry (e.g. big distributors and asset managers) consider that such country by country regulation of the product (as opposed to its sale) represents an unwarranted restriction on the development of the European market financial services and believe that a regime that seeks to protect retail investors interested in such products by means of regulation of the distribution rather than the product is more appropriate. The Commission is expected to monitor the situation and consider solutions in respect of these products in the coming months.

We welcome the Commission's initiative to establish expert groups to look at alternative asset classes and hope that in due course a similar group can be established to look at real estate funds.

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Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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