

## EPFSF Briefing: Investment Funds and Asset Management

*Summary:* The European Commission published in November 2006 its White Paper on Enhancing the European Framework for Investment Funds (COM(2006) 686 final). It outlines the plans for a targeted revision of the UCITS Directives. A proposal is expected in early 2008. In parallel the European Commission has begun work in a number of other areas aimed at addressing the long-term challenges of creating a genuine European internal market. The European Commission's approach is consistent with the European Parliament's Resolution of April 2006. Similarly, the vast majority of stakeholders support plans for targeted revisions but believe there is currently no need for a wide-reaching overhaul of EU legislation in the area of asset management.

### 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 comply with EU laws and regulations and therefore enjoy a European passport, and non-harmonised collective investment schemes – such as property funds, hedge funds and private equity funds, which do not.

Investment funds account for 12.6% of European household financial assets. EU investment funds have experienced five-fold growth in assets under management over the space of 12 years. Growth rates of around 10% per annum are expected in the period to 2010 – which would bring total assets under management by funds to over €8 trillion.<sup>1</sup>

The EU legislative framework with respect to UCITS consists of the UCITS Directives<sup>2</sup>, the soon to be published implementing Directive on eligible assets, and a number of non-binding instruments: the European Commission Recommendations on the use of derivatives (2004/383/CE) and the simplified prospectus (2004/384/CE), as well as on a simplified notification procedure for the distribution of UCITS in host member states (2007/112/CE).

Despite these efforts, Member States have interpreted the UCITS Directives differently with the result that widely varying national 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 costs and resources needed to analyse and assess the different marketing and distribution regimes in each Member State.

### Legislative amendments

In its White Paper the European Commission has identified five aspects of the UCITS Directives which would benefit from a targeted revision. It plans to publish exposure drafts later in March. These will then be subject of public consultation for three months. The European Commission is expected to publish a formal proposal amending the UCITS Directives in early 2008. The five areas are as follows:

#### Improved Notification:

The European Commission is proposing to reduce the administrative burdens that must be satisfied before a fund can be marketed in another Member State. This should streamline the current notification procedure. The host state supervisor would retain responsibility for ensuring compliance with local marketing rules. In its Impact Assessment<sup>3</sup> accompanying the White Paper, the European Commission notes that the current notification procedures are cumbersome, time-consuming and expensive and are a barrier for the cross-border distribution of EU regulated funds.

<sup>1</sup> EFAMA Fact Book, 2006

<sup>2</sup> 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.

<sup>3</sup> Commission staff paper accompanying the White Paper on Asset Management, November 2006

#### Facilitation of cross-border fund mergers and pooling

The common view is that European UCITS funds on average are of sub-optimal size and therefore consolidation is needed, in order to bring efficiency (e.g. lower costs and higher performance) to the industry and benefits for the investors. For example, CRA, in a study commissioned by the European Commission to feed into its impact assessment accompanying the White Paper, estimated that annual savings of up to 17 basis points could be gained if European equity fund sizes converged on those of the average US fund<sup>4</sup>.

The European Commission plans to create the appropriate legal and regulatory conditions to allow funds to merge across borders. These rules will require advanced disclosure of the merger and permitting the unit-holder to redeem the investment free of charge. The European Commission also intends to put forward proposals permitting the pooling of assets.<sup>5</sup> This would require amendments to the current diversification rules of the UCITS Directive. The European Commission has also committed itself to reviewing some of the related tax implications. It plans to issue a Communication on the subject.

#### Management company passport

The right of a management company to passport their 'collective portfolio management' services was first introduced in the last revisions to the UCITS Directive in 2002. The passport concept has manifestly failed. As the expert group report on fund efficiency puts it, "we are not aware of any UCITS which is managed by a foreign management company."<sup>6</sup> The creation of a real management company passport it is argued would enable an asset management company to enjoy economies of scale. Costs between €500,000 and € 1 million per management company were noted. The European Commission plans to develop a European passport for UCITS management companies. The scope of the passport will need to be established but would permit management companies with authorization in one Member State to manage funds in other Member States.

#### Simplified Prospectus

The simplified prospectus is the main tool for informing final investors about UCITS and to enable them to make an informed decision. There is common agreement<sup>7</sup> that the current format does not provide investors with clear, concise and comparable information. The failure most likely derives from trying to do too many things at the same time: provide regulatory information (get a higher degree of comfort in the cross-border notification process), marketing tool, and financial education. This failure has probably to be attributed to the deficient specification in the Directive. The European Commission will therefore come forward with amendments to the UCITS Directive to clarify the 'fundamental objectives and guiding principles' of the simplified prospectus. These would then have to be filled in by means of comitology based on a review of the existing Recommendation by the European Commission on the simplified prospectus.

#### Strengthening supervisory cooperation

Given that the changes proposed by the European Commission are intended to increase the ability of asset management companies to operate cross-border, it is keen to ensure that the UCITS Directive includes provisions that allow for effective supervisory cooperation. The European Commission is therefore planning to table proposals to strengthen the provisions of the UCITS Directive relating to competent authorities and supervisory cooperation. These amendments will be modelled on the relevant provisions of the Prospectus Directive and MiFID.

#### **Complementary initiatives**

In addition to the planned revisions to the UCITS Directives the European Commission has committed itself to carry out work in a number of other areas. It has not yet decided whether this might in time require further action (legislative or non-legislative) at European level.

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<sup>4</sup> Potential cost savings in a fully integrated European investment fund market, CRA, August 2006.

<sup>5</sup> In a first instance this should cover 'entity pooling'. The European Commission will also further explore the possibility of 'virtual pooling' which would permit the coexistence of different funds with each participating fund maintaining ownership over its assets.

<sup>6</sup> Report by the Expert group on Investment Fund Market Efficiency, July 2006

<sup>7</sup> See summary of both the first and second workshops on the simplified prospectus.

The areas of work include:

- Communication/Recommendation on delegation of custodial functions by UCITS depositories. There has been discussion as to whether a European depositories' passport would serve a useful purpose. Although some big financial intermediaries stress the sizeable economies of scale of such a passport, the rest of the industry, as well as the supervisors and the ECB, are more cautious and question the need for this at the moment.
- Vademecum on the application of relevant provisions of MiFID to UCITS for fund distribution. 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 and other rules applying to the provision of UCITS investment services. Also the optional exemption under Article 3 of MiFID raises issues. Another legal issue under scrutiny is the level of competition among distributors. There is concern amongst asset managers that distribution costs in the EU are too high and that there should be a more 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 spreading.
- Research on investment policies for harmonized and non-harmonized funds and related risk and performance. This relates to the level of financial risks embedded in 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 concept that UCITS should be non-complex and non-speculative financial instruments. 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 to them the most appropriate investment vehicle based on the relevant investor's experience and level of sophistication.

Certain jurisdictions, such as Germany, Spain and Luxembourg, have opened up UCITS to funds of hedge funds and/or property funds allowing retail clients to invest indirectly in these funds. The European Commission has sought to address the problem of diverging national investment rules by developing a common interpretation of UCITS eligible assets. These were adopted by comitology procedure, with the involvement of the European Parliament, in January and published on 19 March 2007. The issue of hedge fund indices was excluded from the definition. CESR was asked to reflect on this issue and came out with its initial thinking in a consultation paper in early February. According to this paper UCITS should be permitted to invest in indices of hedge funds if certain strict criteria are met: they represent an adequate market benchmark, and their methodology is independently verified and has been made public.

- Review of the options for the creation of a common European private placement regime for qualified investors, creation of an expert group on open-ended real estate funds, and a report on the need and options for developing a single market framework for certain retail-orientated non-harmonized funds. There are investment products (e.g. hedge funds, private equity funds and real estate funds) which are becoming more and more popular with institutions (who demand investment flexibility beyond that permissible in UCITS) and with retail investors. Such funds fall outside the scope of 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 impossible) is widely thought to be an unwarranted restriction in the development of the European single market - a simple pan-European private placement regime to such investors, along the lines of that created under the Prospectus Directive, has been suggested as a fair and pragmatic step in the wholesale market. Second, there is the equally important but distinct issue of whether such products should be available to retail investors. While some national regulators judge that domestic regulation of these financial instruments is appropriate and call 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 financial services market 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.

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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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