



**POSITION PAPER ON THE EXPERT GROUP
REPORT ON INVESTMENT FUND MARKET
EFFICIENCY**

20 September 2006

ALFI would like to congratulate the Expert Group for the excellent report (the “Report”) it produced on Investment Fund Market Efficiency. ALFI also salutes the European Commission for having set up the Expert Group and facilitated its discussions. The document identifies the most important expectations of the industry and its opinion on how to achieve an integrated single market for investment funds. ALFI welcomes the opportunity to comment on this important paper and urges the Commission to act on those areas where there is an agreement from the industry as soon as possible.

ALFI is the representative body of the 1.6 trillion euro Luxembourg fund industry. It counts among its membership asset managers from various horizons and a large variety of service providers. As one of the main gateways to the European and global markets, Luxembourg is the largest true cross-border fund centre for promoters from diverse origins.

1. SUMMARY

- a) The report acknowledges the huge success of UCITS in the past decade, both inside and outside of the EU and the de facto gold standard status of UCITS on international level. We fully agree with the Expert Group on the need for an efficient use of the passport in order to foster price competition and improve investor choice and performance. We are also of the opinion that more mutual cooperation between EU and third country jurisdictions is desirable.
- b) ALFI also agrees with this approach of the report regarding the competitive risk represented by less regulated products and its suggestion to improve UCITS market efficiency and bring greater regulatory flexibility without jeopardizing investor protection.
- c) We fully agree too with the Expert Group’s statement that “the notification process has become a re-authorisation procedure”. The length/cost of administrative procedures for getting investment funds to the market are a real burden for the industry. We welcome the idea to remedy this situation by modifying the existing procedures. However in our view one should examine in-depth the feasibility of the alignment of the authorization and notification rules along the Prospectus Directive timescale which is recommended.
- d) The report suggests to revise rules regarding the simplified prospectus and to publish a “summary prospectus”. We are also of the opinion that focus should be put on this area. However the definition of “summary” should be clarified. Furthermore a standard text should be defined.
- e) In line with the Expert Group’s conclusions, ALFI believes that a common mechanism for merging investment funds should be agreed in order to exploit economies of scale in the industry. There is a need for a legislative framework that

would provide equal level of investor protection and we share the concerns expressed in the report as to the reflection that has to be carried out regarding the rights that investors in UCITS should have and the role of regulators in cross-border mergers of funds. In our view however the adoption of a Directive on the taxation of fund mergers would be an extremely ambitious project seen the European legislative procedure requirements and length in the fiscal area.

- f) With regard to the tax treatment of investors and investment funds, our Association agrees on the need for further convergence and supports the recommendation made by the report to the Commission to take immediate action where breaches in existing treaties are identified.
- g) ALFI also approves the Expert Group's position regarding the industry's initiatives concerning standardized fund processing on European level.

However:

- h) The report recommends to generalize commingling possibilities at a European level by removing provisions precluding master-feeder structures and other forms of entity pooling. It also suggests that CESR provides clarification and education on virtual pooling techniques. ALFI agrees with the recommendations above as regards virtual pooling, but we would like to insist on the fact that allowing master-feeder type structures should only be considered once registration procedures have been simplified and rationalized sufficiently.
- i) It is ALFI's opinion that potential advantages from a management company passport will be outweighed by added legal and regulatory uncertainty as well as significant risk created by the duality of supervision.

The report states that fund managers should be able to provide core management services to all types of funds domiciled in other Member States and recommends to replace the notion of head office by a "key activities" concept. Should some management company be allowed to establish activities outside the fund domicile, the notion of head office should be replaced by key activities. Certain defined key activities should remain in the domicile of the fund to facilitate the control of the fund by the local supervisory authority.

- j) We agree with the Expert Group that several pre-conditions must be prior to establishing a depositary passport and the suggestion that branches of banks from other Member States should be able to act as depositaries. We are also of the opinion that capital requirements of depositaries should be harmonised. In our view the delegation of pure safe-keeping of assets to a global sub-custodian based in another jurisdiction raises concerns as to the ability of this institution to perform its tasks correctly and should only be allowed subject to meeting specific conditions.

2. GENERAL REMARKS

The Expert Group has rightly pointed out in the Report that although UCITS have witnessed a huge success over the past decade the industry is now facing new challenges in terms of increased cross-border competition, product innovation and creation of non-UCITS savings products. Inefficiencies related to too strict provisions such as administrative delays in getting investment funds to the market also hinder the creation of a true single market. ALFI welcomes the suggestions made in the Report as to the steps to take in order to overcome existing difficulties. ALFI believes however that fostering efficiency should not be achieved at the expense of today's high standard of investor protection. Moreover, cost efficiency should not only mean a reduction of costs for the fund professional only but also for the investor. Finally the cost of new regulation will in any event have to be considered and measured in relation to the extent of expected improvements.

3. GETTING PRODUCTS TO THE MARKET MORE QUICKLY

a) **Authorisation and notification**

Long authorisation and notification procedures are an obstacle to exploiting opportunities in the fund industry and competing with other less regulated products. As already mentioned in our response to the Commission's Green Paper in November 2005, we firmly believe that the simplification of existing registration requirements and the streamlining of related procedures are paramount to the efficiency of fund distribution in Europe. The recent CESR's Guidelines attempting to simplify and lighten the existing procedure was a first step in this direction but are not sufficient to ensure that such a procedure does not remain a re-authorisation exercise. We therefore support the view that difficulties relating to cross-border fund notification should still be given the highest priority. Moreover a simplification of registration and notification procedures would help foster competition and industry consolidation, thereby reducing the overall cost for the final investor.

The Report makes a series of recommendations to remedy the current situation, advocating to remodel the product authorisation and notification on the Prospectus Directive requirements rather than relying on a collective investment undertaking service passport. We agree that a service passport would put the perception of the UCITS brand at risk and support the Expert Group's approach.

The Report suggests to introduce a maximum initial home state **authorisation** of 20 business days together with material changes to that authorisation subject to a 10 day maximum. It also suggests to require a home control authority to host control authority notification, the host State **notification** being brought down to a maximum of 3 days.

Such a system would indeed be very efficient provided an analysis of the possible consequences of adopting the Prospectus Directive's rules is carried out.

The Report repositions the simplified prospectus as a summary prospectus which would be detachable from the full prospectus and could be used independently. In our view the name "summary prospectus", especially if it is a document attached to the full prospectus, could be confusing. The aim of such a document should be to help retail investors make an informed decision, not to provide legal or regulatory information. The simplified prospectus format should be standardised (both the headings and some of the wording of the content where appropriate and feasible). As to the proposals made with regard to the language used for the document, a translation of the standard terminology available in all languages would in our view be sufficient. We agree with the Report as to allowing the addition of information relevant to a specific host State without the need to re-authorise or formally notify the document to the control authorities.

Furthermore, given the negative experience the industry had with the simplified prospectus, it could be advisable to test the model with retail investors before launching any final document. Finally, it has to be underlined that having a summary prospectus will not help solving problems caused by local marketing arrangement rules.

b) Facilitating UCITS mergers

ALFI agrees that the ability to consolidate two or more funds cross-border may help in encouraging the creation of larger funds, thereby contributing to further cost reduction. ALFI would urge the European legislator, however, not to underestimate the complex legal issues surrounding cross-border mergers and the creation of a relevant legal framework for such operations. As mentioned in the Report there would indeed be a need for the envisaged legal framework to cover corporate and non-corporate funds in order to provide an equal level of investor protection. The various suggestions put forward in the Report with regard to investors' rights are a positive step in this direction. However certain modifications of company law could be required as a consequence of the report's various suggestions (for example as regards voting practices in cross-border mergers of funds) and such a process might take a very long time. Our Association is also of the opinion that clear responsibilities should be defined on a supervisory level. Furthermore ALFI considers that in this regard an amendment to the UCITS Directive would be preferable to the drafting of a separate text for practical reasons.

Nonetheless we do not entirely agree with the Experts Group Report's conclusion that "alternative techniques to accomplish such an operation are complex and time consuming" and we are of the opinion that techniques such as amalgamation of funds can be equally efficient. In this respect, and taking into account the fact that the harmonization process of merger rules could be rather long, we would support bi-lateral or multi-lateral discussions with regulators in the meantime regarding the possibility to implement these schemes on a cross-border basis.

ALFI agrees that concentrating on tax barriers and related practices that presently prevent the bringing together of assets across borders in a tax neutral and efficient manner is a

good approach. However, hoping for the adoption of a new Directive in this area in the short term might be wishful thinking since legislative texts are subject to a unanimous vote from Members States on European level.

c) Allowing pooling techniques

ALFI sees benefits in cross-border asset pooling which can help reduce the fragmentation of the European fund market whilst maintaining product diversity. We agree that pooling techniques can also benefit to investors in terms of better trade execution and lower transaction and custody. As regards pension funds we would support the review by CEIOPS of the Members States' transposition of the IORP to confirm that pooling is permissible and the coordination of EU countries' position on OECD level to reach international recognition of fiscally transparent entities. We are also of the opinion that the facilitation by the EU Commission of a pragmatic approach among European tax authorities towards such mutual recognition of fiscally neutral structures would be desirable in the meantime.

Regarding entity pooling however, ALFI is of the view that if master-feeder structures are permitted on a cross-border basis PRIOR TO improving registration/notification procedures for cross-border fund sales, such structures may then be created with the sole purpose of circumventing registration requirements for passported funds.

The result would possibly be in a more "unified" but sub-optimal market, characterised by unnecessary fragmentation and unnecessary costs due to artificial two-tier structures. It would also complicate regulatory oversight and would not be without legal uncertainties in a multi-jurisdictional environment.

Although master-feeder structures can have a real role in facilitating certain types of structures, ALFI is of the view that they must not be allowed to result in a "second-best" single market. Thus, cross-border master-feeder structures should be considered only once registration procedures have been simplified and rationalised sufficiently to ensure that such structures are not used to circumvent them.

4. MAKING THE MANAGEMENT COMPANY PASSPORT WORK

As already stated in our response to the Commission's Green Paper, the potential cost savings from a "management company passport" would be outweighed by added legal and regulatory uncertainty. Although the Report concludes that the control of risk by the management company would be facilitated when all activities are carried out by the same company and that supervisors that are closest to the performance of the management activities will be better able to monitor and intervene, in practice the splitting of the responsibility for the supervision of the management company and the fund across jurisdictions as well as the removal of the head office concept would give rise to other types of risks: legal uncertainty, notably as to the fund's domicile, to the fund's

nationality, to its place of submission to tax and finally, to its regulatory regime. Should some management company be allowed to establish activities outside the fund domicile, the notion of head office should be replaced by key activities. It is our opinion that certain defined key activities should remain in the domicile of the fund to facilitate the control of the fund by the local supervisory authority.

As to the Report's suggestion to allow MiFID compliant companies to manage UCITS, we support the view expressed by some members of the Expert Group that the MiFID authorisation is not sufficient to ensure the existence of the technical and human resources necessary to operate a UCITS. Moreover the implementation process of MiFID is far from being terminated and there are still many discussions as to the interpretation of its provisions. We would therefore advise not to envisage any additional legislative move in this area for the moment.

5. MORE FREEDOMS FOR THE DEPOSITARY

ALFI agrees with the Report's conclusion that there is no common definition of the depositary's role and responsibilities and that the depositary has a key role to play in terms of investor protection and confidence. As underlined in the Report the divergence between the various legislations principally relates to the definition of asset safekeeping. The oversight function is a vital part of the UCITS regime that, to date, has been instrumental in ensuring a high level of investor protection. ALFI currently believes that adequate oversight is best achieved if the depositary, administration, transfer agent (and management company) of an investment fund are placed under the authority of the same supervisor.

Allowing the appointment of a depositary in another jurisdiction than that of the fund may therefore be envisaged only if the oversight duties and responsibilities of a UCITS depositary are clarified and harmonized.

Cost and economies of scale are also advanced in the Report as a reason for changing the current practice. However, the cost of safe-keeping is relatively low in the overall value chain due to strong competition in this field. Moreover, economies of scale have already largely been achieved through the delegation of the pure custody function. Therefore ALFI believes that other areas require more immediate attention and will bring greater benefit to the investor (e.g. by removing distribution barriers) without increasing regulatory risk.

ALFI wishes to point out that the use of branches is a first phase towards the emergence of a sector of specialist depositaries without the need to tie up equity for each particular country. We therefore welcome the Expert Group's recommendation in this regard.

Until a true harmonization is realised, the Report also suggests to allow the delegation of the pure safekeeping function to a custodian located in another country. ALFI would like to underline that such delegation requires the use of a network of sub-custodians with whom the depositary must be able to communicate directly. This includes the selection of sub-custodians who offer all the guarantees of competence, honourability and have the necessary financial resources. Furthermore an excessive concentration of the tasks on a single correspondent of the depositary should be avoided. This can be an issue since the appointment of a “global sub-depositary” does not in principle enable the obligations of the depositary to be satisfied.

In any case the delegate custodian should indeed agree contractually to comply with the depositary’s local regulations with regard to safekeeping and restitution of assets. Nonetheless we would like to underline that in certain jurisdictions local supplementary regulations could still apply to the delegate custodian and be contradictory with those of the depositary.

We support the view expressed in the Report that a harmonisation of capital requirements for depositaries would also be necessary to support the sound management of risks and ensure investor confidence.

Finally ALFI would also encourage the carrying out of a study on various aspects related to the depositary issue before taking any legislative step towards allowing more freedom in this field.

6. CONCLUSION

ALFI welcomes the Expert Group’s publication of its Report which we believe will contribute to further reflections on the improvement of the fund market efficiency. ALFI appreciates the quality of this document and is of the view that it addresses many critical concerns for fund professionals.

Overall ALFI supports the proposals made by the Commission with regard to the following:

- The modification of the existing authorisation and notification procedures, provided that they are legally feasible and that the new simplified prospectus concept truly becomes a useful marketing and information tool.
- The facilitation of fund mergers through a modification of the UCITS Directive together with the agreement on alternative techniques that also prove to be useful such as the amalgamation of funds.

- The promotion of virtual pooling techniques including in the pension funds area.

In ALFI's view, the regulatory structure, the efficiency of the home/host relationship between supervisors would require substantial improvement before the following proposals could realistically be considered:

- Recognition of entity pooling (master-feeder type pooling)
- Review of the scope of the management company passport
- Greater freedom of choice of depositaries

ALFI will support and be happy to contribute to any further effort initiated by the European Commission with a view to proposing solutions to fund market efficiency issues.