AUTORITÉ
DES MARCHÉS FINANCIERS

AMF

INTRODUCTION

The Autorité des Marchés Financiers (AMF - French financial markets regulator) has received with great interest the proposals made by the three experts' groups drawn from the asset management industry that the European Commission has set up. The AMF wishes to thank all of the participants for the high quality of the work they have accomplished. These efforts demonstrate the dynamism of the industry and its desire to open the European asset management market further. This increased openness requires rationalization of costs, which in turn requires certain changes in the markets' present framework, and also ceasing to isolate the market for non-UCITS funds.

As Charlie McCreevy, European Commissioner for Internal Market and Services, recalled during the open hearings held in Brussels on July 19, this wider opening also requires a clarification of marketing rules. Beyond the question of the coordination of the European Directive for UCITS and the MiFID (Markets in Financial Instruments Directive), it would be useful to improve conditions of competition among players and among products, and to provide savers with the ability to make well-informed choices. While this is of course a medium-term goal, given the diversity of the processes of retailing funds in Europe, the European Commission should give priority attention to this question.

However, given the need to arrive at a true internal market in asset management services while maintaining a high level of protection for investors, this response will remain limited to the various recommendations made by the experts' groups and on the means of implementing them. In this way, the Autorité des Marchés Financiers hopes that this response will be useful to the Commission as it draws up its White Paper.

Part One: Report on the efficiency of the markets

In general, the high level of precision in the recommendations made by this experts' group deserves commendation. It would seem that most of them can be implemented in relatively quick succession, depending on the regulatory frameworks that need to be set up, However, some are rather ambitious, given the conditions required for supervising the suggested schemes. The AMF's only regret is that the experts' groups have not provided stronger economic arguments to justify the interest of their proposals.

Certain recommendations also appear insufficient. For example, the experts' group recommends that the present simplified prospectus be replaced by a summary of the prospectus, in accordance with the model provided in the Prospectus Directive. While on the one hand the suggested approach may well make it possible to simplify the current model, it does not on the other hand guarantee pertinent information to savers. In effect, without a minimum harmonization of the essential information to be included in the simplified prospectus, regulatory choices will lead to a least common denominator for the information provided to investors.

Preamble: Increasing the size of the funds managed and economies of scale

The AMF finds that, in general, the experts' reports do not provide supplementary figures to support their view that the economies of scale permitted by expanding the size of funds managed and rationalizing product lines would be substantial, and would benefit investors.

Though it does not wish to contest the value of such economies of scale, the AMF recalls the observations made on this point in its response to the Green Paper: current studies are based on a transposition of results observed in the American market, while the context of the European market is very different. There are great disparities among the levels of fees in different member States, which are not related to the average size of funds in each country. The European market is also characterized by a low level of competition in retailing, which means, among other things, that there are no systematic mechanisms for reducing management fees as a fund grows in size, as is true of the breakpoints in the United States.

Pending the work on this subject that the Commission may be engaged in, and the publication of its own analyses now under way, AMF observes that the data available (see Lipper, March 2005, "Economies of scale and consolidation in collective funds," a study of Luxembourg-based equity funds) provides some interesting nuances. An analysis of the Luxembourg situation has obvious interest insofar as these funds are widely exported to all of Europe:

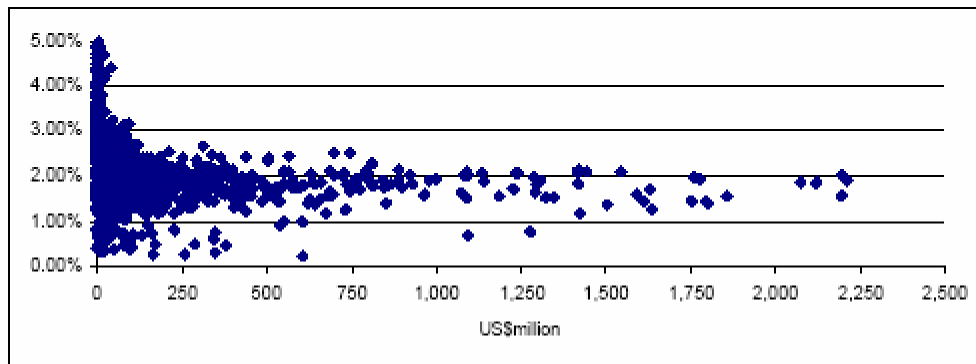
Size of the Fund	Average TER	Average mgmt. fee	Number of funds
< US$ 5 million	3.55%	1.36%	351
< US$ 10 million	2.34%	1.39%	262
< US$ 25 million	2.01%	1.35%	578
< US$ 50 million	1.81%	1.29%	410
< US$ 100 million	1.75%	1.29%	333
< US$ 250 million	1.76%	1.35%	334
> US$ 250 million	1.67%	1.30%	292

Source: Lipper

Average TER drops sharply with average fund size at the lower end of the table, for funds of $5 m to $50 m, given also the fixed costs of launching a fund. At a size of over $50m, it drops much more slowly, or even rises again with very large funds, a paradox that is hard to explain.

In examining the data on a homogenous category of funds (such as actively managed equity funds) in greater detail, it would seem that the average figures provided in fact conceal wide disparities within each of the different categories. What seems clear is that small funds, with less than $50m in assets under management, have a very broad range of fees, varying from 0 to 5%, while larger funds tend to converge more closely around an average figure of 1.8%, which remains relatively constant regardless of the asset manager or type of management, and whatever their size.

Chart 3.1 TERs for 'retail' actively managed equity funds



The scattering of points shows that:

-below $50m, many small-size funds are able to offer a TER as low, if not lower, than larger funds;

-above $50m, there is no noticeable trend of a TER declining in inverse proportion to growth in the size of the fund.

This in no way corresponds to the theory of an automatic and continuous drop in TER as the size of a fund increases.

This phenomenon can be explained by certain characteristics of the market:

-The absence of breakpoints, already mentioned above;

-The great variety of small-size funds, including niche funds that at times perform very well, but in exchange require high fees;

-The impact of fixed costs is still noticeable in small funds, and can explain the greater frequency of high TERs for this category (although there is still a need to explain why some funds can still propose low TERs). On the contrary, the impact of fixed costs for larger funds is minimal, as costs become increasingly proportionate to the volume of funds under management;

-The current low level of competition at the retail level.

In any case, the example of the most widely sold funds in Europe would appear to suggest that an increase in the size of a fund does not automatically benefit the investor. From the AMF's point of view, it remains indispensable to reflect on the question of competition in retailing funds, in order to guarantee that the reforms foreseen are of interest to investors.

In this respect, that fact that the measures proposed offer a wider range of possibilities to access the French market for more complex products − using a system of organization which has become more international − reinforces the AMF's desire to emphasize the regulation and control of the marketing of financial products.

I. Authorization and notification of funds

The report considers that the current procedures are too long and insufficiently harmonized. To a degree, the AMF shares this conclusion, but considers that the June 2006 recommendations of the CESR, to be implemented as soon as possible (the AMF's target is January 1, 2007) should permit a notable improvement in the situation.

The Report suggests changes in the EU Directive in order to:

-Reduce the time required for authorization to 20 working days: This should be possible for the AMF, and is indeed not far from current practice;

-Reduce to ten days the time taken to authorize a modification in a prospectus, including setting up a new sub-fund. While the AMF shares the view that the time needed for the authorization of minor changes in a prospectus should not be the same as that required for initial authorization, the proposal in the report goes too far in that certain major changes may indeed require more time for examination than the initial application for authorization. In particular, a new sub-fund may prove to be so different from other sub-funds that it should be considered as a separate fund. From that viewpoint, it would not be desirable to set up a streamlined procedure for all new sub-funds, other than to create a bias in favor of choosing such compartmentalized funds.

-Reduce the time for notification to three working days: This may prove totally unrealistic for the regulatory authority of the host member State. Experience shows that basic data which later permits the market regulator to monitor the marketing of a product may be incomplete or poorly provided. The required review, which includes assuring that the French translation of a prospectus is comprehensible to an investor, cannot be completed in three days.

The report also favors summarizing the prospectus to make it a more pertinent tool for decision-making. However, it suggests adopting the legal regime provided in the Prospectus Directive, under which the issuer is only committed to the full text of the prospectus. This is not appropriate to products coming under the UCITS Directive, many of which are actively marketed to relatively unsophisticated investors. It is inconceivable that, in the event of legal disputes, such clients be referred to the conditions set down in a full prospectus to which their attention had never been previously drawn. The report proposes to translate only the simplified prospectus, which makes the above proposal even more doubtful. In general, the concepts in the Prospectus Directive were drawn up for a public of persons active in financial operations, and are not in themselves adapted to investors in UCITS. Indeed, their application to UCITS is not a foregone conclusion.

Hence, in terms of its contents, the Prospectus directive is not appropriate to those products for which information on the issuers is less important than a description of how the product functions. In fact, information provided to investors through the prospectuses for these products is generally insufficient. It therefore seems preferable to revise the implementing texts of the Prospectus Directive so that prospectuses' contents are better adapted to the nature of certificates and structured bonds, rather than trying to align the UCITS Directive with the Prospectus Directive.

In any case, the approach the European Commission had embarked upon − organizing workshops which bring together market professionals, consumer groups and regulators − should be continued. It would be good if

this process were to lead to a simplified prospectus with a fixed and limited number of headings giving the essential elements of information enabling investors to make fully-informed choices, together with a harmonization of what is to be included under these headings.

The recommendation that a funds management company may itself certify that the prospectus is in conformity with the directive should be further explored. It goes in the sense that the AMF wishes to encourage, that is, a greater assumption of responsibility by market players. The AMF does not see the need for the market regulator of the Home member State to provide a form of authentification to a file that a management company addresses to authorities of the Host member State.

Rather, the idea that it is up to the competent authorities to transfer the notification files relieves the management companies of a responsibility incumbent on them. Moreover, such a procedure does not necessarily save time: If certain clarifications seem necessary to the authorities of the Host member State as they examine the file, the intervention of the competent authorities of the Home member State will, quite to the contrary, slow down the examination. This authority often plays a role only in the domiciliation of the fund and does not have a ready contact with the management company, which may be located in another member State.

The AMF notes with interest that the report does not question the independence of member States in terms of their competence in marketing questions. In this respect, the report mentions only that this competence cannot be exercised in the case of the contents of a simplified prospectus, a point with which the AMF agrees.

Hence, the report puts forward some interesting new ideas on the time allowed for approval and the increased responsibility of fund management companies in certifying that their materials are compliant with the EU directives, and likewise on the question of revising the contents of the simplified prospectus. It recognizes the usefulness of retaining a notification procedure.

Those of the report's recommendations inspired by the Prospectus Directive on the question of time allowed for the notification procedure, of prospectus content, and of the rules for determining responsibility for a prospectus, are not entirely appropriate to what is involved in the regulation of UCITS.

II. Cross-border mergers of funds

The AMF's response to the question of permitting cross-border mergers of funds recognizes that such operations could potentially create economies of scale, which justifies that the question be studied, while noting that a modification of the directive would be necessary to make them possible. Indeed, this approach raises the least number of questions of principle relative to the sharing of responsibilities among regulatory authorities.

The AMF has however insisted on the highly theoretical nature of the assumption that such mergers could serve to reduce fees to clients − given that fees are often higher in member States where such merged funds are likely to be domiciled than they are in France. The AMF has also noted the technical conditions that must be fulfilled to ensure that permitting such mergers provide investor protection. These conditions should ensure that:

- The merger be approved by the competent authorities of the member States of the merged funds, particularly to verify that these funds are compatible; the merger can only be authorized for funds that are approved for marketing in each member State;
- That information on the merger to investors in the funds be provided in accordance with the rules of each country involved in the merger;
- The merger be tax-neutral for investors,
- Due notice be given of differences in information to investors that result from the merger;
- That a procedure be set up providing for a report by the statutory auditors on the conditions of the merger, to be made available to investors.

It would also be desirable that information provided investors be further harmonized in Europe, and that the conditions for purchasing and redeeming shares in a fund be improved so that a merger does not become an occasion to reduce the quality of information provided to investors or lead to a less efficient handling of their orders.

Last, it would be necessary to regulate the information published on the merged funds in a consistent way, so that mergers are not used to cause less well-performing funds to disappear off the horizon[1].

Recent articles in the press[2] have confirmed that there are certain risks involved for investors. These articles call attention to the reduction in fees following on certain mergers, but also note that:

- Mergers can alter the initial goals of investors when the funds merged have different profiles ; these mergers can even have tax consequences;
- Investors in the best performer among the funds merged may see this performance diluted in the assets of the new fund.

However, these risks are reduced if they are for the sole purpose of rationalizing funds that are duplicated under the laws of different member States of the European Union, as the European industry affirms.

Unfortunately, the Commission experts' report does not provide any new information showing the economic benefits of mergers of funds, and once again makes reference to studies that transpose the American experience and contain several biases (detailed in the AMF's response to the Green Paper), without taking into account the specific qualities of the European market, which is characterized by large differences in fees among member States, independent of a fund's size.

---

[1] In the United States, the performance of the fund considerer the acquirer is retained.
[2] Article in the Wall Street Journal of March 9, 2006 on mergers of funds in the United States.

It confirms that a modification of the directive is necessary and echoes most of the conditions for respecting investors' rights posed in the AMF's response, such as:

-The possibility of exiting a fund that is about to merge without having to pay fees and the right to take a position on the merger in accordance with domestic law;
-The right to be free of any unfavorable tax consequences as a result of the merger;
-The right to remain invested in a UCITS that is authorized to be marketed in his home country,
-the right to adequate information at the time of the merger, including a comparison of fees, of investment policies and of the merger procedure: For the AMF, this means information equivalent to that provided in the case of mergers of national funds in the investor's home country − a point with which the working group also agrees − as well as informing the investor as needed of any changes in the information provided him in the future because of different legislation on the subject that may come into force over the lifetime of the UCITS. The working group suggests that advance information be provided to the concerned regulatory authorities, which is indeed desirable.

The experts' group has sought to take the division of responsibilities among market regulators into account. Rather than approval by each regulator concerned, the group proposes that only the regulator of the fund that will disappear with the merger express an opinion, so as to ensure that that interests of investors who effectively change funds are appropriately protected, as well as those of the regulator of the merged fund. This proposal is interesting in that it would simplify the process, and makes perfect sense for the merger of clone funds; it might however be less appropriate for funds that perform differently, and for which a risk of performance dilution of the surviving fund has been identified. As concerns publication of performance figures after the merger, the experts' group refers to existing standards; from the AMF's viewpoint, these should be at a sufficiently high level.

Lastly, the experts' group accepts the idea of an evaluation of the merger operation by a statutory auditor, but does not specify that this report be made available to investors, which appears necessary and indeed applies to the merger of funds in France.

Hence, the proposal made is for the most part in line with that of the AMF. However, it should be recalled that:
- the information to be supplied to the public should include any differences in the periodic reports provided investors, and emphasize how to acquire and redeem shares in the fund;
-the statutory auditors' report on the merger should be provided to investors;
-it may be necessary to harmonize the standards applied to the presentation of the performance of the funds at the time of the merger; that the industry has done work on the subject of mergers does not in itself guarantee that there are real common standards;
-the proposal that only the authority regulating the fund that is extinguished needs to take a position on the merger is really only appropriate to the merger of clone funds.

III. Pooling Techniques

1. Cross-border master-feeder funds

Cross-border master-feeder funds permit management companies to offer funds in each member State which are registered in that State and subject to its laws, thereby taking into account the preferences of investors in some countries for funds established under their own national law, while at the same time permitting centralized management and the resulting economies of scale − and all this under a system less costly than that of delegated authority. It might be useful to reflect on motivations for this preference before trying to circumvent it.

The AMF has made known in detail what it considers to be the minimal technical criteria needed to ensure the viability of such a mechanism:
-The master and feeder funds should be UCITS;
-An exchange of information among the regulatory authorities of member States having approved either the master fund or the feeder funds, so as to ensure effective supervision of the entire construct. This would include recognizing that the regulatory authority of the feeder fund also has the right to investigate the management company of the master fund. This also implies that regulators need to have very similar understandings of the supervision of fund management companies and of how to sanction any breaches of the rules. Regulators still need to make further progress on this operational convergence. An exchange of information between the statutory auditors and the depositories of the funds should also be set up, and the following questions addressed:

-A requirement for equal treatment of investors in different feeder funds and any investors in the master fund, both:

- On the question of defining a feeder fund: Should it invest 100% of its assets in the master fund? What should be the level of its cash holdings? How to take into account the case of feeder funds that add an "active" dimension to their investments in the master fund (such as adding an exchange rate guarantee or a partial or total guarantee of the capital invested, whether condition or absolute) etc;
- In managing purchases and redemptions;

-A requirement that the prospectus note that a fund is a feeder fund;
-A resolution of the possible differences in information provided to investors: The feeder fund established in member State A will be subject to that State's information requirements, even though it will only be able to provide concrete information given to it by the master fund established in member State B, which is subject to different regulations.

Since some of these conditions are quite strict, the AMF believes that such funds are not likely to materialize in the short term.

The AMF also observes that the diversification rules given in the directive do not permit a feeder fund to be a UCITS. However, the report admits that some amendment of the directive is necessary, and that master and feeder funds should indeed be UCITS.

Without giving precise answers to all the issues raised, the report suggests certain changes and limits that might make it easier to take them into account. In particular:

- It foresees master-feeder funds only within the same group, with a common management control or indeed a single manager. This proposal partly meets the AMF's concerns about possible difficulties in identifying and sanctioning the person(s) responsible if the interests of the feeder fund are prejudiced, and also about the possibility of circumventing the rules for supervising the delegation of management that makes a master-feeder fund possible;
- It very pertinently takes into account possible problems of transparency of cascaded fees in the feeder funds and master funds. The AMF considers the suggestion in the Commission's recommendation that the manner of providing information on the TER used for funds of funds should be employed for simplified prospectuses as well.

However, there are certain areas on which the report remains vague:

-It does not consider the requirement that feeder funds invest at least a minimum amount of their assets in the master fund, as does French legislation on master-feeder funds;

-More generally, the report does not give sufficient attention to the question of equality among investors that is raised by master-feeder arrangements, for example the dangers arising from investments in relatively illiquid securities. In the case of two feeder funds, one with a relatively small number of individual investors, and the other with an institutional investor, which both feed into the same master fund, it is likely that major redemptions by the institutional investor could have an impact on the value of the master fund and in the end also on the holdings of investors in the other feeder fund.

-it likewise does not give sufficient attention to the concrete difficulties that regulators would have in the supervision of such constructs (although these are reduced if there is a single manager), or to the need for said regulators to achieve a higher level of coordination and of convergence of their practices than that which prevails today.

Moreover, structures that permit a single feeder fund to invest in several master funds can be so complex that they are difficult for retail investors to comprehend. It would therefore seem advisable, at least in an initial period, that these structures be limited to qualified investors.

Lastly, not all the examples given in the appendix to justify the economic interest of joint management techniques are convincing. Fund management companies have already succeeded in minimizing the cost of placing orders and grouping them on trading tables that handle several funds, without however providing pooled management.

Taken together, the proposals of the working group form an interesting basis for reflection. However, they need to be supplemented by:

- **Greater attention to the question of equal information for all investors in such funds**
- **An examination of the concrete conditions of cooperation among regulators.**

2. Virtual pooling

The experts' group report suggests that virtual pooling practices already in operation in several member States of the EU be recognized and expanded to the European level, permitting cross-border pooling.
In its response to the Green paper, the AMF noted that in the absence of precise legal and operational conditions, virtual pooling does not offer sufficient security to investors, particularly in cases where the segregation of assets and equality of investors are not guaranteed.

As concerns the economic interest of the proposal, the report justifies use of the virtual pooling technique on the basis of the economies of scale that it might generate. It is suggested that given the very size of the pool, joint management would make it possible to reduce fees related to the management of the UCITS that are members of the pool, such as management fees, transaction fees, depositary fees, etc. These economies of scale can benefit both investors and the management companies participating in the pool. However, the report provides no examples of funds which reduced their management fees as a result of pooled management.

To demonstrate the economic interest of virtual pooling, the report gives the example of the greater value of orders that result when the manager of a pool passes them globally, enabling him to negotiate lower transaction fees. It should be noted, however, that this example has its limits insofar as negotiation of transaction fees already exists in practice, in particular when a manager groups orders issued on behalf of several UCITS that he manages.

Lastly, the AMF wishes to stress that the expected economies of scale can be offset in whole or in part by the IT costs related to the operation of virtual pooling. Certain professionals admit that the joint management technique is only of real economic interest in cases where a fund management company structures its range of UCITS in such a way that each is managed in a pool. It has been observed that those management companies that had set up virtual pooling mechanisms for some of their Luxembourg-based UCITS had to abandon this technique because it was not economically viable. Nor does this technique seem to generate economies of scale for investments in over-the-counter or bond markets.

As to the conditions for setting up virtual pooling, the AMF calls attention to the fact that the report fails to emphasize the principle of asset segregation in pooled portfolios. Yet, assets comprising a pooled portfolio must be segregated according to the portfolio to which they belong. Such segregation makes it possible to guarantee the rights of shareholders of UCITS included in pools and avoid conflicts of interest.

While sophisticated techniques now exist which can guarantee to the strict identity of portfolios managed to a certain extent, they also entail high costs and imply rebalancing operations which have the effect of passing on the costs of purchases and redemptions of such funds to all investors in funds managed through a pool.

Hence, the AMF would recall that virtual pooling should have an impact neither on all those involved in the funds participating in the pool, who retain the same rights and above all the same obligations in terms of monitoring, nor on the characteristics of these funds (legal form, objectives and investment policies), nor on the tax regime applying to them. The latter requires a very clear legal framework.

The AMF also finds that virtual pooling has been conceived to allow each fund to be divided into "packets," each of which may be managed in a different pool. This "n to N" organization is already difficult to manage for master-feeder funds, which involve clearly established legal entities (See above). Initially, at least, it would be better if all of the assets of a single fund were managed in the same pool.

The AMF also stresses that virtual pooling also requires setting up systems for delegating management among the fund managers concerned, failing which there is a possibility of circumventing the delegation requirements in the UCITS directive. Only such a delegation system, in which a manager located in a given national territory remains responsible to the competent authority which approved the pool, provides the level of responsibility sufficient for effective supervision.

The AMF notes with interest that the report mentions certain legal and technical difficulties involved in pooling, but without suggesting any solutions to them. For example, the CESR requests that European regulators adopt a common approach to different forms of pooling, determine the questions raised by its implementation, and make recommendations about the application of pooling to UCITS. The Commission is also asked to give CESR an assignment to reflect on the questions related to pooling listed below, in order to confirm the observations of the experts' group. These include:

- Confirming that virtual pooling is compatible with the UCITS III directive;
- Clarifying the accounting and evaluation principles that apply to pooling mechanisms;
- Confirming that the investment and accounting policies of pooled funds remain independent;
- Confirming that pooling has no impact on the respective obligations of financial managers and custodians of UCITS participating in a pool;
- Confirming that the pooling process dose not affect the ownership of a fund's assets and, as appropriate, determining the conditions necessary to ensure this right of ownership;
- Confirming the requirements for identifying the counterparts in the case of joint trading accounts.

Further, there are certain issues raised by pooling that need to be examined, including:

- determining the potentially dilutive effects of pooling on participating funds,
- determining information requirements,

- identifying the operating risks involved in setting up pooling arrangements, and the measures foreseen to limit such risks,
- studying the possibility of modifying or clarifying the UCITS III directive to enable a depositary to name an overall custodian located in another EU member State, to be tied to a contractual commitment on the part of the custodian to respect local regulations applied to the depository, with a view to maintaining the same level of investor protection.

The AMF observes that the report of the experts' group identifies real issues involved in virtual pooling, in particular its possible dilutive effects, information to investors or shareholders in funds that are pool members, operating risks, and the depositary's delegation of its custodial functions outside of the country of domiciliation of the fund.

On this last point, if the respective delegation of custodial responsibility by the respective depositaries of pooled funds to a single custodian is a legitimate means of facilitating the settlement of the combined orders of pooled funds, as well as the operations of sharing out and rebalancing, it is nonetheless questionable in the framework in the context of a transnational system, i.e., when the custodian is located in an EU member State other than the State in which the fund participating in the pool is domiciled. In effect, the definition of custodial responsibilities for assets and the regulation of depositaries vary from one member State to another. Given the legal difficulties involved in delegating custodial responsibilities to a firm in another State, the work of European regulators should first concentrate on national virtual pooling mechanisms.

In conclusion, the AMF considers that the recommendations concerning the virtual pooling technique are not really operational, in that in the great majority of cases they require European regulators to confirm their agreement with the views stated in the report of the experts group on the real points under discussion.

The AMF nonetheless favors in-depth study by CESR of the feasibility of cross-border pooling. The report has not, however, dealt with the practical questions involved in monitoring such mechanisms, which could also be studied by CESR.

IV The "European passport" of a fund management company

The AMF's answer to the Green Paper, which was favorable to the study of a "European passport" for management companies, underscored the problems of sharing responsibility among regulators, and the difficulties involved in supervising a mechanism in which a fund and its management company are subject to different regulatory authorities. It nonetheless also noted that while the delegation approach, which is the alternative mechanism used today, sets up a system of responsibility that is easier for regulators to implement, it is also more costly insofar as the directive states that a management company cannot just be "mailbox." Above all, the present situation excludes funds managed by medium-sized management

companies from the European market, even though it is precisely these companies that ensure strong competition in the industry and favor the development of financial innovation.

The report points to the ambiguity of EU texts concerning the present scope of the “passport,” in particular the limited nature of the passport mechanism as described in the directive. In effect, the Directive also requires maintaining a head office in the member State where the company has its registered address, and considers that a UCITS is located in the member State where the aforementioned address is located. While admitting that this requirement prevents the real development of a European passport for a management company, the working group asks whether member States are prepared to interpret the legal texts in a manner permitting the realization of a real passport. This does not seem possible without a clarification of the texts that would effectively amount to a substantial modification.

The group did not reach a consensus on the activities to be covered by the passport, and on whether or not to maintain the provisions of the directive concerning a head office. It would be useful to list the regulatory problems that would arise from a pure and simple withdrawal of said provisions, which would for example permit valuation of a fund in another member State.

While other proposals in the report, such as increased cooperation among regulators, a reexamination of the link between management companies and activities that might fall under the European passport in the light of the MiFID, are interesting in principle, they are not sufficiently precise to permit surmounting existing obstacles to the passport for management companies. Having failed to reach consensus on the content of the passport for management companies, the working group could only study conditions for the viability of such an approach in terms of supervision by market regulators; this cannot be summarized in a simple call for cooperation among them. Nonetheless, the AMF considers that it should be possible to overcome these obstacles, since the question of the splintering of supervision has already been handled in other areas.

As far as concerns management companies located in third countries, the requirement that local branches be set up in every member State in which the UCITS is domiciled should be maintained. In effect, European regulators cannot cooperate efficiently when financial management is carried out outside of Europe, while there is now no cooperation with regulators in third countries. Without reciprocity, it does not seem advisable to apply such a passport to third-party management companies.

VI. The depository

The AMF’s response to the question raised in the Green paper as to whether it is advisable to study broader freedom of establishment for depositaries, and how to do so, underscored the difficulties posed by this idea, given the absence of harmonization of the depositary function among member States. (Today

such freedom is restricted by the directive, which states that the depository must have its registered office in the member State of the fund involved.)

The experts' report makes the same observation, and does not propose any major legislative changes in the short term, but rather suggests a two-stage approach, relegating study of the harmonization of the depository function to the longer term, but nonetheless proposing certain changes in the short term.

However, the extent of differences, not only within the notion of the depository, but also in that of the custodial function, seems to prevent even the short-term progress suggested in the report, such as the possibility of delegating the custodial function to other member States. In France, its definition is being reformed to take into account the verifications which must be undertaken in the case of derivatives, with the notion of "holding a position." Overall, one cannot but doubt the practical possibility of attaining the proposed short-term goals without first solving the question of the harmonization of definitions and responsibilities of the custodian.

The recommendation to abolish the requirement to redeliver securities in any case cannot be expressed so readily. The responsibility of a depository is a complex subject, and each member State must determine the balance of this responsibility relative to the other players. In the French system, this serves as an important safeguard for investor protection. Any changes must be based on a detailed study of how either model applies when investors are compensated when a foreign sub-custodian defaults. On this subject, see also the comments on the report on alternative asset management.

Part two: Report on alternative asset management

Although it does not actually define the industry, this experts' group report is of remarkable quality in its description of the alternative asset management (hedge fund) industry and its contributions to the financing of the economy and the proper functioning of financial markets. This elucidation is most useful at a time when many market players are concerned about the lack of transparency in alternative asset management. However, some of its suggestions need to be put in perspective.

The work of this experts' group shows that the industry has two aspects, with very different approaches:

- On the one hand, firms based in the United Kingdom that manage most of their assets in Europe are subject to regulations adapted to sale principally to highly qualified investors who conduct their own verifications;

- On the other hand, firms based in continental Europe are subject to a graduated set of regulations depending on the expected buyers of the fund: There is comparable light regulation of funds destined for qualified investors, and a system of approval for funds aimed at relatively wealthy individual investors (“affluent retail”), in particular for alternative funds of funds.

In its response to the Green Paper, the AMF informed the Commission that it was open to the study of the harmonization of the idea of private placements in Europe, and that it was concerned about not adding confusion to the label “UCITS” by opening them up largely to hedge funds. It gives more support to the idea of a specific EU investment vehicle dedicated to hedge funds and possibly initially limited to alternative funds of funds (See below).

The report on alternative asset management funds makes recommendations appropriate to a broader distribution of hedge funds and underscores the need to eliminate certain obstacles, whether at the level of institutional investors or linked to services provided to managers of these funds, including depositories, custodians, and prime brokers. The AMF has noted that the report has abandoned pursuit of the question of private placement, which would have permitted easier marketing to wealthy investors, for the broader and more doubtful goal of unhindered distribution to all types of investors.

In this respect, the AMF can only agree with the observation made in the report that: “conditions (should) be introduced to prevent access to hedge funds by investors for whom such investments are not suitable” However, the AMF favors ways of arriving at these conditions that differ from those suggested in the report.

Essentially, the report recommends:
-that member States recognize that a broader distribution of hedge funds is already permitted by Community texts;
-that integration of hedge funds into UCITS not be sought;
-that member states abandon the limiting quotas on hedge funds imposed on certain institutional players;
-refrain from insisting on a local depositary or requiring that the local depositary accept the requirement to redeliver securities in any case.

Some recommendations appear pertinent, others are doubtful in their present form or call for clarifications on the part of the Commission staff if the latter wishes to retain them.

Among the interesting approaches proposed, the most promising in the short term is the recommendation to permit an expended scope of cross-border distribution of alternative asset management funds of funds. Appendix 1 of the report of the experts’ group in effect demonstrates that this type of fund is either already sold, or may soon be sold, to individual investors in certain countries of the European Union, with rather low access requirements (€10,000 for French alternative asset management funds of funds). Without doing violence to the results of work in CESR on this subject, the working group’s

approach seems more efficient and safer than that of making funds that track an index of hedge funds eligible for the UCITS directive. The soundness of this approach is now being discussed in CESR.

If so assigned by the European Commission, it would be useful for CESR to undertake work on the definition of standards. This would be a matter of creating a European regime for alternative asset management funds of funds that would be based on appropriate regulation of the market players involved and on a set of minimum verifications that the manager of the fund of funds would have to undertake in order to ensure an optimal level of security for the individual investor.[3]

This would appear to be the only viable approach in terms of regulation. The idea of automatic mutual recognition of member States' national regimes for hedge funds seems unlikely to materialize in the absence of common standards. France, in any case, could not recognize a national regime that does not provide sufficient guarantees. Until such time as there are common standards, progress can also be made through the mutual recognition of national regimes on a bilateral and voluntary basis.

One recommendation also focuses the assignment given the International Organization of Securities Commissions (IOSCO) aimed at setting up standards in the areas of valuation and management of assets by hedge funds.

It recommends that the subject should be discussed in this forum in a process involving close cooperation with the industry. While the AMF agrees with this approach, and participates in the work itself, it is nonetheless true that this recommendation is not the last word on the subject of monitoring the industry's respect for future standards. European authorities are likely to be interested in encouraging hedge funds' voluntary respect of such principles by furnishing a framework that would encourage them to do so. The examination of how rating agencies respect the IOSCO principles, which was followed up by surveillance work by the European Commission[4] and CESR, might be a pertinent example for the future monitoring of IOSCO best practices on the valuation of hedge funds.

<u>The AMF is more doubtful about those recommendations</u> that are based on an interpretation of MiFID that permits broad retailing of hedge funds.

[3] It should be noted that SC5 of IOSCO, chaired by the AMF, is ready to begin such work on funds of funds, as a continuation of its March 2006 report on "The Regulatory Environment for Hedge Funds - A Survey and Comparison, Report of the Technical Committee of IOSCO." This commitment demonstrates the shared willingness of the market regulators that are members of SC5 to address a subject that has become a matter of major and urgent concern to them. This is an additional reason to include the market regulators that are members of CESR in a work program aimed at creating a harmonized European regime for indirect alternative asset management.

[4] Message of the EU Directorate General for Internal Market and Services, January 9, 2006.

These recommendations derive from a reading of MiFID according to which member States are justified neither in closing their markets to foreign funds, whether registered in other EU member States or offshore, nor in including minimum levels or other conditions for investing in such funds when they set up national rules for alternative asset management funds. According to this view, the only guidelines for investing in a fund are the provisions of MiFID concerning the adequate or appropriate nature of the fund relative to the characteristics of the buyer. Paradoxically, the report states that the entry level of €50,000 could be maintained.

That would appear to be an entirely inappropriate reading of the directive. As Commissioner McCreevy has already very opportunely observed at the open hearing held on July 19, 2006, the implementation of the recommendations of the experts' group would mean that the marketing of UCITS would be subject to greater control than the sale of hedge funds, except for the minimum sale level of €50,000.

At the same time, if one way of reading MiFID is to place this type of minimum in question, it would also mean that individual investors' access to this type of product should be subject to greater ex-ante control – for example prohibiting solicitation – and ex-post supervision than is called for by the experts' group, in order to preclude any risks of large-scale unsuitable sales. Such sales could only put individual investors' confidence in all kinds of mutual funds into question.

More generally, the AMF maintains that it is necessary to retain rules that prevent investors for which such products are not appropriate from buying into hedge funds. It is not enough simply to rely on the test of appropriateness suggested in MiFID, **particularly in that this text does not govern the case of making such purchases directly, without recourse to an investment adviser**. Simply adopting a floor of €50,000, as the report suggests, appears arbitrary. It would be more consistent to limit these products to qualified investors, in the sense of the Prospectus directive.

Moreover, the views on the role of the depository and the requirement that this function be located in the country of the fund do not appear very well defined.

They are above all a rather premature criticism of certain national modes of regulating alternative asset management, given that these countries' experience in this matter (including that of France) seems to be too recent to permit a sure and definitive evaluation. In this respect, the recent signature in France of certain trilateral agreements by custodians and internationally known prime brokers seems to show that the legal framework for agreements among asset managers, depositories and prime brokers is not an insurmountable obstacle for the major international players in the alternative asset management market. At first analysis, it would seem that the development of hedge funds is held back more by regulations and the proclivities of institutional investors than by the system of depository responsibility. Rather, this legal framework would seem to provide the necessary guarantees for both individual and institutional investors, who are not always able to make the minimum verifications needed to permit them to invest in hedge funds under what they consider to be sufficiently safe conditions.

The report observes that the role of the depository is most limited, as operationally the Prime Broker is the custodian of the fund's assets (the global custodian). As concerns supervision of the management company's decisions, the report considers that the legislation on the investments of asset management companies is sufficient in itself, and that no additional supervision by depositories is necessary. Moreover, the latter are not well equipped to oversee OTC derivatives operations. But the French system does precisely require a local depository and specifically defines its attributes, including in terms of supervising OTC derivatives operations.

In any case, the contention that the requirements stated in the French model are in violation of Article 17 of the draft directive on implementation of Directive 2004/39/CE appears to be wrong. In effect, this article does not pertain to the depository's responsibility relative to assets entrusted to him, but pertains rather to the possibility for an investment services provider to avail itself of the assistance of a third party. Obviously, the maximalist character of this implementing directive only applies to the subjects it covers. Local requirements on responsibility are therefore not incompatible with the directive.

This said, the AMF is not against European institutions joining with professionals – asset managers and depositories – in jointly studying optional mechanisms for optional attenuated responsibility for keepers of custodial accounts, insofar as the fund is exclusively reserved for qualified investors. This subject could be raised once discussion is opened on a "European passport" for depositories. These discussions could clarify the precise implications of the provisions of Article 17 and concentrate on the question of custodial responsibilities.

Part three: Report on private equity

The experts' group report gives a general definition of private equity as means of financing start-ups and young growing companies, as well as projects for transferring the ownership of companies. The report notes that there is no harmonized framework for this type of activity in the European Union (EU), which explains why the terms "private equity," "risk capital" and "venture capital" are used interchangeably in Europe even though these three financing "strategies" have different objectives.

The experts' group has found an interesting way of specifying the principal characteristics of private equity activity, including not only the fact that it is governed by two major bodies of rules – "light" rules laid down by member States and rules of good conduct the profession has imposed on itself – but also the nature of the investors (mainly "sophisticated" investors fully able to take independent investment decisions and understand the risks inherent in them) and finally the lack of liquidity of the investment vehicles employed,

which generally pre-set the period of shareholding as ten years. The AMF notes that the various observations made by the experts' group indeed provide a representative image of private equity activity.

In this respect, the AMF has in fact prepared a study on private equity, entitled: "Private equity, portrait of a growing market," which will be published before the end of 2006, and which takes stock of the activity both in France and in the rest of Europe. The study will soon be available on the AMF website.

Given these observations, particularly related to the absence of any specific European regulatory framework for private equity, the experts' group makes five proposals for action at the European and national level. These aim for:

(i) Better communication among member States on their national mechanisms governing private equity;

(ii) Drawing up a common definition of the eligible investor (the concept of the "prudent person"): The report justifies this recommendation by the fact that conditions are too different from one member States to another, and are often obsolete or inappropriate to permit an investor to buy into a private equity vehicle;

(iii) Taking into account the specific character of private equity activity within the area of asset management when European authorities draw up rules on the subject, whether these are directives, recommendations, or positions;

(iv) Setting up a transparent tax regime for private equity investment vehicles in all member States. The object of this recommendation is to avoid double taxation of an investor's capital gains. The principle endorsed in the report is to recognize the tax transparency of private equity funds and to tax the investor's capital gains only in his home country;

(v) Adapting a common definition of "private placement." This recommendation is intended to facilitate the "retailing" of private equity funds within the EU. The report specifies that this definition should not be a matter of legislation, insofar as the notion of "private placement" in private equity is a matter of private negotiations between professionals and "sophisticated investors." The report proposes to develop this definition of "private placement" on the basis of the definition of "qualified investor" that already exists in European legislation.

The AMF notes that these action proposals are more general than operational. They aim at setting up a common approach to private equity, without any legislative action and relying on self-regulation in this industry. They also make recommendations on tax transparency, which is now a substantial obstacle to the development of private equity.

Nonetheless, it is unfortunate that the proposals do not also contain precise draft directives for their implementation. This approach of the experts' group gives the impression that the industry is not making

any request for harmonized regulation of private equity funds, but rather seeks strengthened cooperation among member States, particularly in taxation.

In conclusion, if the goal of the report, which is to permit the development of private equity activity at the European level, deserves support, the means the report suggests for reaching it at times appear weak or limited:

- Some recommendations are too general, making it impossible to draw up concrete measures for implementation;
- The more precise recommendations, aimed at drawing up a common definition of “eligible investor” and “private placement” do not actually propose any such definitions;
- The report specifies that the implementation of its recommendations does not necessarily require legislative or regulatory requirements, but can be accomplished by establishing joint positions, recommendations or even codes of good conduct. This proposal seems hard to reconcile with the goal of developing a specific European framework for private equity activity.