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**Mrs Klára Cetlová**

Director of Financial Market Department

ESC Member

Prague, September 25, 2006

**Subject: Czech comments to the industry reports on improvements to EU investment fund framework**

Dear Mr. Wright,

Please find enclosed our comments to the industry reports on improvements to EU investment fund framework prepared by the Czech National Bank and Czech Finance Ministry.

Yours sincerely

Klára Cetlová

**Mr David Wright**

The Director

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ANNEX

**Response to the industry reports on improvements to EU investment fund framework  
prepared by the Czech National Bank and Czech Finance Ministry.**

**I. REPORT OF THE EXPERT GROUP ON INVESTMENT FUND MARKET EFFICIENCY**

- 1. The Group recommends amending the UCITS Directive to align its authorization and notification rules along Prospectus Directive timescales, meaning authorization of funds in 20 business days and electronic regulator-to-regulator notification taking a maximum 3 days.**

It is not possible to compare Prospectus Directive regime and fund approval regime pursuant to the UCITS Directive. Firstly the authorization of the fund usually does not comprise approval of the prospectus only and secondly, the approval in Prospectus Directive regime is based on verification of formal prospectus requisities while approval of the fund prospectus is more content-focused.

Nevertheless, we do not object against shortening approval periods provided (i) the maximum would be fixed at 25 business days for funds created by management company which already launched new funds, (ii) 40 business days for the first fund launched by management company or funds launched by a new management company and (iii) the time period does not earlier than all requested documents are submitted. Proposed notification period could be shortened if subsequently the content of the notification is reduced and residual host member state competency would be abolished. Therefore, the scope of the notification has to be discussed first.

However, the sentence "...the home CA must notify the UCITS operator of all such facts within 10 days..." is not clear. Does it mean, that authority has to request additional information within 10 days or that it just has to notify the applicant that it will request it later?

- 2. The Group recommends revising the simplified prospectus so that it becomes a fully and automatically recognized document containing key disclosures for investors. The simplified prospectus (including any translations thereof) should be communicated as part of the cross-border notification and should not be the subject of further examination by the host authority.**

No revision of the simplified prospectus content will substitute proper investor education so that the investors know that studying such documents can help them understand their investments. We do not believe that such initiative will bring success. As for the second sentence we support such opinions, however unified and enforceable legislative requirements are essential assumption to achieve this goal. The implementation of EC recommendation on simplified prospectus indicated weaknesses and risks of this approach.

Changing the label "simplified prospectus" to "summary prospectus" is useless, it could also bring additional costs for fund management.

- 3. The Expert Group recommends expanding the UCITS Directive to include arrangements for fund mergers to take place, subject to safeguards that protect investor interests and enjoy supervisory confidence;**

We do not object against these proposals provided such safeguards will be met. We would like to point to the fact that merging of corporate funds is more complex process than merging of unit trusts (these are just pool of assets without legal personality). There is even special directive providing only for rules for cross-border mergers of corporations.

- 4. The Group recommends taking actions to ensure that fund mergers do not give rise to adverse tax implications.**

In principle, we would agree with this recommendation.

- 5. The Expert Group recommends removing provisions of the UCITS Directive that preclude master-feeder and other forms of entity pooling;**

Removing provisions precluding entity pooling can be meaningful if such structures will be allowed for these special purposes only, if safeguard standards (i.e. prohibition of double charging) proposed by the expert group will be fulfilled. Furthermore due to practical regulatory reasons both feeder and master fund must be located in the same member state. The investor must be aware of the fact that the assets the fund invests are intermediated via unit/share of the „master“ fund. It must be also clearly stated that such exemption is without prejudice to basic risk spreading principle required by usual UCITS funds products. In our opinion there is no need to additionally define new categories of funds involved in entity pooling such as “DUCIF” and “DUCOF” because the proposed objective can be reached by amending the current provisions for investing in other funds (i.e. article 24) .

We also recommend for clarifying conditions such as “same asset management group” or “common control”

As regards virtual pooling we do not agree that every such technique is already fully possible according to the UCITS directive. Full usage of virtual pooling at the very first stage of i.e. fund bank accounts can jeopardize current legal and accounting standards on strict segregation of assets requirements for each fund and also requirements on depository duties. However we agree this does not preclude the possibility of the depository to delegate its custody function. In such case it is possible that fund assets are held on other securities accounts together with other securities of custodian fund clients. In such case it is usually the depository responsibility to ensure that fund assets have to be clearly identifiable at the custodian account. We also recommend that report should specify more examples of virtual pooling (such as aggregation of client /funds/ orders by investment firms)

- 6. The Group recommends building an understanding between regulators in order to allow the wider application of virtual pooling techniques;**

We support this proposal so that the current scope of virtual pooling and its interpretation among member states will be clarified. However, we think that asking for CESR’s advice in such scale as proposed in report is too ambitious. For example it would be hard task to “confirm that the quality of ownership assets remains unchanged and, if appropriate, develop conditions to ensure that such is the case” as it has to be taken into account that some virtual pooling mechanisms are dependent on national legislation governing “ownership” as such and this legislation is different in each member state.

- 7. The Group recommends introducing necessary flanking conditions such as recognition of the right for the depositary to appoint a custodian based in another EU State (see depositary section below).**

We support this proposal since it is very difficult for smaller fund and depositories structures (without worldwide global custody network) to deal in foreign securities. The Czech law enables under certain condition delegation of depositary primary custody function to other entities.

- 8. The Expert Group recommends that the issue (of management company passport) be revisited by eliminating the inconsistencies and omissions that have robbed the management company passport of its effect;**

We support that the scope of the management company passport has to be made clear. We agree that passport concept as provided in UCITS III directive already includes the right to manage foreign corporate funds.

- 9. The Group recommends extending the right to manage funds on a remote basis to all types of funds (not just corporate funds);**

We do not support this proposal because of supervisory reasons. Furthermore in current legal conditions it is already possible to manage foreign non-corporate fund via delegation mechanismus. We believe that the need of management companies to be located in one member state and establish (and manage) non-corporate funds in other jurisdiction is motivated in particular by tax reasons only. Management company can establish a non-corporate fund in the same country and passport it in all EU countries.

- 10. The Group recommends removing the "head office" principle or replacing it with a "key activities" or similar concept;**

Firstly we believe that the head office principle corresponds more with the supervisory needs than key activities. Secondly such changes would probably be not consistent with other financial markets Directives dealing with European passport. We do not support this proposal at the moment.

- 11. The Group recommends providing clarity on the activities and services which the management company can provide and clarification which of them it can provide on a cross-border basis.**

We fully support this proposal.

- 12. The Group recommends enabling branches of banks from other Member States to act as a depositary;**

We fully support this proposal. According to the Czech law the depositary can be either domestic bank or branch of foreign bank located in the Czech Republic.

- 13. The Group recommends allowing the depositary to be free to delegate asset-safekeeping to custodians in another EU Member State, subject to the custodian complying with the depositary's local regulations on a contractual basis.**

We support this proposal since it is very difficult for smaller fund and depositories structures (without worldwide global custody network) to deal in foreign securities. According to our

opinion there is no obstacle in UCITS directive and the Czech law enables under certain conditions delegation of depository primary custody function to foreign entities.

- 14. The Group recommends that in a longer term, the Commission should 1) harmonize the capital requirements of depositaries and study the barriers to further harmonizing the role and responsibilities of the depository**

We support this general proposal with following objections: (i) It is important to make clear whether the “capital requirements” mean “own funds” or CAD rules (ii) capital requirements should be provided only for non-regulated entities that are not subject to their own capital requirements (such as i.e. CAD) (iii) to harmonize the depository activities within the EU the common understanding of its supervisory functions have to be clarified first (iv) choosing of appropriate institution to carry out the depository function will remain on national legislation discretion (as it is the current state) The depository is usually responsible to investors for damages caused by breach of his duties. Taking into account the regular fund size we believe such responsibility could be carried particularly by regulated entities such as banks.

## **II. DEVELOPING EUROPEAN PRIVATE EQUITY**

**„The Expert Group encourages EU institutions and Member States to consider establishing – in non-legislative form- a common understanding of the parameters of „private placement“. This could involve building on, with adaptation in relation to experience/dealing frequency, useful provisions of existing Community law as regards the notion of „qualified investors“ which can be approached without triggering mandatory disclosure or conduct of business rules.“**

The creation of a common definition of „private placement“ is considered useful, however when fixing i.e. the minimum investment threshold regional differences have to be taken into account, so that qualified investors from countries with lower income per head would not be discriminated by such a common definition.

## **III. MANAGING, SERVICING AND MARKETING HEDGE FUNDS IN EUROPE**

- 1. The majority of the Group recommends against reopening negotiations on the key provisions of the UCITS Directive with a view to facilitating the authorization of a broad range of funds of hedge funds as UCITS. A minority considered that the time was right to broaden investment rules and other provisions of the UCITS directive to allow funds of hedge funds to be authorized as UCITS compliant funds.**

The broadening of investment rules in order to recognize funds of hedge funds as UCITS compliant funds would introduce a completely alien investment vehicle into the UCITS class of funds and thus jeopardize the UCITS “brand” as a whole. Therefore we do not recommend to facilitate the authorization of fund of hedge funds as UCITS. Furthermore it is important to

remind that recently issued CESR advice on eligible assets of UCITS already enables under certain strict conditions to acquire hedge fund in form of close end fund as a transferable security.

- 2. Whilst concerned about the limitations associated with product regulation, the Group recommends that European institutions and national authorities take all non-legislative steps needed to give effect to the mutual recognition of retail-oriented hedge fund products. These should be mutually recognized as suitable for sale to the investing retail public.**

This aim could be hardly accomplished without legislative amendments.

- 3. „The Group recognizes the potential value in allowing retail investor access to hedge fund based investing by authorizing UCITS to invest in derivatives on hedge fund indices. However, the majority of the Group recognizes the validity of concerns regarding the reliability and functioning of hedge fund indices. The Group, with exception of one member, recommends that UCITS investment in derivatives based on such indices be deferred until concerns regarding the structure and performance of hedge fund indices are resolved.“**

We agree with the majority of the Group. Such products are not suitable to UCITS retail investors.

- 4. „Regulators and industry bodies should remove absolute or arbitrary quantitative restrictions on hedge fund based investing which are imposed on some institutional investors. The Group advocates removal of any arbitrary and/or regulatory prohibition or restriction. The „prudent man“ principle should be more broadly applied“.**

Generally we agree with this recommendation but different types of institutional investor should be taken into account. Especially pension funds and also insurances should have limited access to high risk assets due to the role these entities represent in social systems. For example pension funds in the Czech Republic are allowed to acquire other assets. Such acquisitions are subject to expert care rules and these investments may not represent more than 5% of pension fund assets. Moreover investment limitations are not always stipulated by national legislation only but also by EU-law (i.e. Directives on life and non-life insurance). Pension funds and insurances should invest only a very limited part of their capital into relatively high risk assets, therefore it is not appropriate to change this rule.

- 5. „The Group recommends that effective steps be taken to ensure a measured and appropriate implementation of the Capital Requirements Directive – one which does not result in exaggerated and prohibitive restrictions on bank investment in hedge funds. In addition, the Group recommends that the European Commission provides for appropriate provisioning requirements under its forthcoming proposals for SolvencyII.**

In this context the fact that hedge funds do not guarantee full transparency of their investment strategies and the valuation of their assets must be taken into account. Apart from that hedge funds obviously lack effective supervision over investment policy.

- 6. „Member State regulators should not impose a requirement for the appointment of a domestic custodian upon European hedge funds. The Group recommends that the provider of custody services to a European hedge fund should be a regulated provider of custody services, either domestically or in another Member State together with a minimum assets requirement. In**

**addition to the requirement that a custodian be regulated in a Member State, the Group would support the use of minimum assets test by Member State “**

The distinction between supervisory duties of depositary and custodian function has to be taken into account. To perform supervisory duties it is important to retain effective protection from any eventual failure of the investment manager to manage the fund in accordance with its investment guidelines and against any failure of the custodian even in case of Qualified investors. It can be accomplished only through a domestic entity, therefore the depositary has to be local. Nevertheless, as we stated above (see 13.) since it is very difficult for smaller fund and depositories structures (without worldwide global custody network) to deal in foreign securities, it is necessary to enable under certain condition the delegation of depositary primary custody function to foreign entities.

Prague, September 2006