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A S S O C I A T I O N

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## **DFIA COMMENTS**

**On**

### **REPORTS OF THE EXPERT GROUPS**

The Dublin Funds Industry Association (DFIA) is the representative body of the international investment fund community, representing the custodian banks, administrators, managers, transfer agents and professional advisory firms involved in the international fund services industry in Ireland. Given that as at end of July 2006 there were 3,838 Irish domiciled funds, including sub-funds, with a Net Asset Value of €33 billion, (2,185 Irish domiciled UCITS funds, including sub-funds with a Net Asset Value of €03 billion), all developments in the European investment funds arena are of particular interest and relevance to the Irish industry. As such, we appreciate the opportunity to provide comment on the Reports of the Expert Groups on Investment Fund Market Efficiency and Alternative Investments.

The DFIA welcomes the publication of these reports and acknowledges the substantive contribution this process should make in providing a catalyst for a truly integrated and competitive European market for investment funds. In welcoming the reports we would also like to congratulate the Expert Groups on the completeness of the papers and acknowledge that, in our opinion, the reports include the spectrum of issues to be considered and actioned that would be required to deliver a truly integrated and competitive market for investment funds. However, as we have previously noted we would again like to highlight that we see the issues raised as objectives/goals to be actioned/achieved and not merely a menu to pick and choose from. The complete enhancement of the entire framework will take time, but there are a number of issues that can be considered, addressed and commenced in a shorter timeframe than others, achieving real benefits in a short timeframe. Such an interim piecemeal approach to the enhancement of the EU framework should be encouraged and supported. In fact, and again as previously noted, within many of the issues highlighted there are a number of factors and features, not all requiring the same timeframe and level of detailed consideration, everything is not needed before anything is achieved.

Detailed below is our response to the various Reports;

## *Fund Mergers*

This is an issue of particular concern and priority for the Irish Industry. We support the consideration and introduction of cross-border fund mergers and like many industry participants, believe current challenges/issues should be addressed as an immediate priority rather than a longer term project.

Cross-border fund mergers do happen. However, due to local regulatory interpretation and/or legislation, effective barriers to an efficient environment for cross-border mergers are present i.e. while funds can merge into a jurisdiction, they are frustrated through these barriers from merging out. The presence of these barriers prevents regulatory equivalence and introduces governance equivalence issues. As such inactivity or any further delay in creating an environment that facilitates cross-border fund mergers will, due to governance issues, discourage those jurisdictions that have created an appropriate environment from maintaining such an environment.

The European landscape remains dominated by funds that are of sub-optimal size and as a result the significant benefits of scale are being lost; “Despite the fact that the European investment funds market has only two-thirds as many assets as the US market, it has over three times as many funds”<sup>1</sup>. The proposals contained in the Experts Group Report on Market Efficiency regarding fund mergers we believe are suitable, appropriate and achievable and presents an immediate opportunity for the Commission/EU Member States to address current inefficiencies due to the difficulty of achieving cross-border fund mergers.

In January 2005, the INVESCO Think Tank published a report entitled “Benefits of an integrated European Fund Management: Cross Border Merger of Funds, a quick win?” That report identified the economic need for reducing the proliferation of UCITS within the European Union; “scale effect could enable asset managers in Europe to achieve annual savings of between €2bn and €6bn, which could be passed on to investors via annual fee reductions of between 5bps and 15bps<sup>2</sup>.” The report highlighted two very important aspects, which it was felt impeded fund mergers, which were regulatory and tax barriers. We believe that there is a clear economic case for removing such barriers by providing a framework for cross-border fund mergers, and as previously mentioned we would like to see the regulatory barriers e.g. shareholder approval levels, being addressed as a matter of urgency. The re-prioritisation and early consideration of this issue would in the first instance, deliver the scale benefits and secondly; would send out a very strong and clear message that the European authorities are actively seeking and delivering the efficiencies of an integrated and competitive European market. Despite the current fiscal, legal and regulatory challenges to be overcome with a cross-border merger, cross-border mergers do happen. As such, in certain cases, the benefits of merging outweigh the costs and challenges and it is argued that it would be possible, in a very timely way, to address some of the issues, which would reduce some of the associated challenges e.g. shareholder approval. In some jurisdictions for a fund to merge into another fund, 100% of the shareholders who vote must approve the merger activity. Requiring 100% approval is in effect a barrier and as such prevents mergers taking place.

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<sup>1</sup> Report of the Experts Group on Investment Fund Market Efficiency page 10, II.2

<sup>2</sup> Page: 2

Introducing a recommendation, suggestion or even guidance as to an appropriate level of shareholder approval e.g. 75% of shareholder votes supporting the merger required, at least 50% of shareholders votes required and redemption opportunities at no additional cost for shareholders to exit the fund should they so desire; would appear appropriate, would address any investor concerns and would remove one of the challenges, the effective barrier, to merger activity.

IOSCO<sup>3</sup> has already identified a number of common themes and core principles in national regulations concerning mergers and we believe that the adoption of these themes/principles by Member States would be a very positive step towards achieving a harmonised cross-border fund merger regime. We strongly support the suggestion of the Experts Group that in parallel to legislative changes that bi-or multi-lateral discussion might take place between Regulators with a view to implementing schemes of arrangement to facilitate cross-border mergers. We believe this to be a very pragmatic approach, which can build upon the work already undertaken by IOSCO and with the support of the Commission, achieve real progress in a short timeframe.

### *Pooling*

During 2005 two reports were published; “Pooling-How can fund managers respond efficiently to different investor needs?” by the IMA and “Benefits of an integrated European Fund Management: Cross border merger of funds, a quick win?” by INVESCO. Both of these papers highlight the efficiencies that can be achieved through mergers and pooling and comprehensively make the case for the introduction of these techniques on a European cross-border basis. A point to note, in respect of pooling, is that at present many companies are looking for a solution to the pan European pension fund dilemma and many of these companies see pooling as a way of managing the risks and costs on the asset side, as such pooling could be the first action in the pan European pension fund project. However, simply identifying the need and highlighting the benefits is not to be mistaken for an underestimation of the efforts necessary to introduce a European harmonised approach for these techniques.

We support the Experts Group proposals in this regard and believe fostering a greater understanding and appreciation of pooling techniques and methods will help promote the use of pooling structures/products. We would encourage this as a priority. The proposal to establish a specialist expert group to provide further technical advice is to be welcomed. The work of this group would be beneficial to all, as a greater understanding of the finer points of the (fiscal and legal) issues surrounding pooling in the context of ‘virtual’ and ‘entity’ pooling, both of which are capable of achieving the benefits which pooling can offer, is required. Taxation can be an issue when it comes to participation in pooling structures and while some of these obstacles can be overcome by obtaining tax rulings from foreign tax authorities this can prove a time consuming and costly exercise. We believe real progress could be achieved if the Commission could co-ordinate Member States’ representation on OECD Working Party No 1 on Tax Conventions and Related Questions, and propose a basis for international mutual recognition of fiscally transparent entities, with a view to relating this effort to the possible impact on UCITS and their use by pension funds. We would advocate a harmonised approach to pooling as a priority initiative.

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<sup>3</sup> IOSCO – December 2004: Survey on conditions for mergers of Collective Investment Schemes

### *Management Company Passport*

It is agreed that the management company passport is an important step to further develop the European financial services marketplace.

With regard to any perceived difference between corporate, unit trust and contractual structures, again we agree with the Experts Group position that the perceived lack of legal personality of the latter two structures should in no way impact their ability to avail of the Management Company passport.

### *Depositary*

We agree with the suggested approach, which would see an initial focus of the passporting of “custodial” functions.

In addition, we believe that the passporting of the depositary approval/authorisation could be introduced in a relatively short timeframe. Such a passport could allow a depositary approved and authorised in one member state to automatically, on notification, establish operations in another member state to perform the roles and responsibilities of the depositary as determined by the competent authority in that “host” jurisdiction. As such an approved depositary in another member state could by simple notification to the Irish Financial Services Regulatory Authority establish a presence in Ireland and perform the roles and responsibilities of the Trustee/Depositary, as included in the Financial Regulators Notices, to an Irish domiciled fund. Similarly an Irish Trustee/Depositary could by notification establish an operation in another member state and undertake the role of the depositary to a fund in that jurisdiction. We do not believe that there has to be a full range of services passported to achieve “easy” wins. A full depositary passport can be a longer-term objective but there are some short-term goals that can be achieved first i.e. passporting of custodial functions.

## **Alternative Investments**

The analysis of the hedge fund industry as included in the Expert Groups report is very good and covers most key issues/areas.

Given the unique nature of hedge funds, their strategies, objectives and assets it is difficult to envisage how a single regulatory framework might be achieved while still permitting these funds achieve their goals/objectives. Many hedge funds are hugely sophisticated products, which given their complexity, are clearly not suitable for retail investors, regardless of what level of disclosure/information might be provided. We believe that, at this point in time, it would be a wasted effort to attempt to legislate for the sale of such complex funds to retail investors. The hedge fund industry while developing and maturing is still very much a tailored product, built to achieve a specific exposure/return and sold to investors seeking such exposure/return. Typically, such investors would be experienced/professional investors aware of the potential risks and seeking specific exposure/returns. We agree with the Experts Group and do not believe that there is a demand/need for additional legislative amendments to protect such investors from the hedge fund product. We agree with the Experts Group that a harmonised approach to identifying suitable investors is preferred and agree that a minimum subscription requirement of €50,000 should

ensure that proper consideration is given to such an investment. In addition, the suggested regulation of hedge fund distributors under the conduct of business requirements of MiFID would introduce appropriate graduated protection for different investor categories.

While many hedge fund products can be very complex some hedge funds can be quiet simple/unsophisticated and provide a means of reducing exposure/risk for investors. In such circumstances the introduction of the above requirements to all hedge fund products would prevent many “retail” investors access to such unsophisticated hedge funds/strategies. It is these unsophisticated hedge funds that would benefit from further consideration/harmonisation, which would be best done outside the UCITS framework. We believe the review by IOSCO<sup>4</sup> could assist in this regard.

We support the Experts Group suggestion that “an absolute requirement for a local entity to perform custody functions for European hedge funds does not significantly increase the level of investor protection” and believe that the industry should be permitted the necessary freedom to select the most suitable and appropriate service providers for these products. We believe that it is more important that the provider of custody services to a hedge fund be a properly regulated entity with experience of the product(s) and appropriately capitalized. To impose the additional requirement that the service provider must be located in the same jurisdiction as the hedge fund reduces the number of eligible service providers, and in some instances can prevent hedge funds access to wholly appropriate, experienced and well regulated service providers.

## **Private Equity**

The proposal of the private equity experts group is a useful starting point for the discussion/consideration of cross-border distribution of alternative investment funds. Indeed, an agreement among European institutions and Member States on a set of harmonised pan-European rules for private placement or the qualified investors’ concept seems a very pragmatic starting point and one which should not frustrate/restrict the objective of private equity funds.

Again we agree with the expert groups general suggestion that private equity funds do not need intrusive regulatory involvement in the conduct of business and management of assets. What is required is consideration by EU policymakers of the specific characteristics of the private equity industry when reviewing or drafting legislation so as to avoid unintended negative consequences of company law, accounting or financials services initiatives.

**DFIA**  
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<sup>4</sup> IOSCO Technical Committee’s Consultation Report on the Regulatory Environment for Hedge Funds of March 2006.