

REPORT OF THE EXPERTS GROUPS INVESTMENT FUNDS

EXECUTIVE SUMMARY

1. The French Banking Federation (FBF) is the professional body representing over 500 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

As universal banks, the FBF members are highly interested the evolution of the legal framework of the investment funds, for the French industry on investment funds is one of the biggest in the world.

Thus the FBF very welcomes the expert groups' reports and would to take this opportunity to insist on several matters of great importance for the industry. It is now essential, as it was done for the issuers with the Prospectus Directive and the investment services providers with the MiFID to implement a full European passport for investment funds (which means a European passport for the funds, for their management companies and for the depositaries).

2. The experts group's reports

Before developing its detailed comments, the FBF would like to state four preliminary observations on these three reports:

- ↪ First, the FBF notices that the reports do not reflect for the moment the Commission's view but the conclusion of the discussions between experts. Moreover, the FBF underlines that some provisions of these reports don't reflect a consensus between the experts but only a majority view. Indeed, these reports can only be a preliminary support for the further thoughts about the best way to encourage the development of the investment fund industry while keeping a high level of safety for the actors (i.e. risk management), of protection for the investors (especially the retail investors), and of harmonisation.
- ↪ Second, the French industry considers there is no need to elaborate a completely new framework, as far as it is possible to extract some provisions of the UCITS III legal framework and to "import" some provisions from other European directive (especially from the Prospectus directive).
- ↪ Third, the Report on Investment Fund Market Efficiency is probably the most important for the French industry. Thus the main following comments are focused on this report. The Private Equity report and the Hedge Funds reports concern largely the Asset Management industry, even if the Hedge Funds are of great importance in terms of role and responsibilities of the depositaries. Therefore the FBF estimates that it belongs to the Asset Management industry to develop further observations on

the private equity report. As a consequence, the FBF has developed some observations on the Hedge Funds report, but not on the Private Equity report.

In this context, the FBF considers as key elements of the future regulation the European passport for management companies and for depositaries, which involves that the role and responsibilities must be defined. This regulation could be in a Lamfalussy style, with level 2 powers given to the Commission for long term provisions dealing with the conditions of the application of these provisions.

↪ Fourth, the FBF agrees with most of the description made by the expert groups and the evolution which has to be enforced in order to upgrade the legal framework in a way to develop the industry in Europe.

FBF'S RESPONSE ON MARKET EFFICIENCY REPORT

3. The conclusions of the expert group report are summed up in the five following recommendations:

- ❶ Reduce administrative delays in getting investment funds to the market
- ❷ Enable the rapid and efficient merger of funds
- ❸ Allow the centralised (pooled) management of assets owned by different funds
- ❹ Breathe life into the management company passport
- ❺ Provide more freedoms for the depositary

As a matter of fact, the French Banking Federation approves these recommendations. Nonetheless the FBF calls the attention of the Commission on the fact that beyond the legal framework, the industry has to face the Securities Regulators (such as the Financial Market Authority, "Autorité des marchés financiers"- AMF-, in France), for whom the alignment of the regulations on the lower level, in terms of restrictions, could be detrimental to the consumers protection. As a consequence, the FBF estimates that any provision which encourages the reduction of delays or the lightening of obligations must be set up *via* a full harmonisation Directive which would not allow any Member State to set up more stringent provisions in its local legislation.

4. ***First recommendation: Reduce administrative delays in getting investment funds to the market.***

This recommendation is split in two proposals:

- ↳ Firstly, to align the delays on those set up in the Prospectus Directive (*i.e.*: authorisation of funds in 20 business days and electronic regulator to regulator notification taking in a maximum of 3 days).

This is typically a good sense recommendation on which the industry fully agrees. It is necessary to reduce the delays in order to allow the Europe to be competitive in regards with the USA or Asia. The best way is naturally to align the delays on the Prospectus Directive timescales. Thus the FBF strongly supports this recommendation.

But as the FBF noticed that some new products covered by the Prospectus Directive were not allowed in France by the AMF because, among others, the delay given to the authority to analyse the product was too short, it must be highlighted that the shortened delay must not imply reluctance of the local regulators to recognise innovative instruments and therefore to forbid their commercialisation.

Such a consequence would be detrimental in two ways:

- A legal "dumping" in favour of the authorities which would recognise products in the shortened delay;
- The break of the development of the industry in the countries where the authorities would be the most reluctant to recognise innovative products.

Thus it seems necessary, from FBF's point of view, that the new framework will be completed by a guaranty of a fully harmonised application of the Directive principles by every authority in Europe.

- ↪ Secondly, to revise the simplified Prospectus, so that it becomes a fully and automatically recognised document containing key disclosures for investors. In other terms, it means to implement a full European passport for simplified funds.

The FBF fully agrees with this proposal and considers that the Commission should guaranty a full consistency between the Prospectus Directive and the future framework. Thus the FBF strongly supports a unique fully harmonised simplified prospectus but dislikes the “summary prospectus” notion, which is not defined in any European Directive. Furthermore, the terms “harmonised simplified prospectus” were those used by Mr Klinz in the European Parliament report.

Furthermore, the FBF considers that the full harmonisation of the products allowed by authorities and the practices of the authorities to analyse to prospectus (terms of the prospectus, delays) is a key point of the success or the failure of the future regulation. Clarifications are needed on this subject.

The FBF also estimates that a good way to increase the regulators confidence is to associate the depositaries in the notification process and to store the notified documents in a central database, with the promoters of the fund being responsible for updating the database in case of modifications of the funds.

5. Second recommendation: Enable the rapid and efficient merger of funds.

Firstly, the FBF fully agrees with the expert group’s statement: “*the UCITS directive does not provide any mechanism for merging investment funds*”. Thus it seems indisputable that such provisions are essential to improve the efficiency of the Investment Fund Industry.

Nevertheless, as it is stated in the expert group’s conclusions, the Commission should take provision in order to avoid adverse tax implications. Moreover, some company law provisions are to be implemented in order to avoid adverse implications.

The FBF estimates that such a regulation needs a former study of the existing legislations in the member states in the two domains of Company law and tax law. This can be considered as a former impact assessment in order to identify the simplest way to dismantle the adverse implications.

Secondly, the FBF notices that the expert group report does not focus on the role of depositaries in case of a cross border fund merger. The FBF considers that the depositaries have to be informed early in this process, and that the efficiency of the fund merger depends largely of the cooperation between depositaries. Thus it seems natural to set up provisions on this matter.

6. Third recommendation: Allow the centralised (pooled) management of assets owned by different funds.

The recommendation of the Expert group is split in three proposals:

- ↪ Firstly, the removal of provisions of the UCITS Directive that preclude master-feeder and other forms of entity pooling.
- ↪ Secondly, the building of an understanding between regulators in order to allow the wider application of virtual pooling techniques.
- ↪ Thirdly, the allowance to the depositary to appoint a custodian based in another EU State

The FBF fully agrees with these proposals. It seems undisputable that the safety and the efficiency of the management of UCITS depend largely of the flexibility of the pooling techniques.

In this context the FBF wishes, as it was stated concerning the cross border mergers of funds that the Commission take some provisions to avoid adverse tax law and company law implications.

Last but not least, the FBF does not consider as a necessity the implementation of provisions in order to allow the depositaries to appoint a custodian in another EU member state, for the actual legislation is not an obstacle to the development of the virtual pooling. However, such provisions would be subject to the custodian complying with the depositary's local regulations on a contractual basis. In each member state there is a large number of custodians being able to provide such services. The FBF would rather welcome some provisions on the role of the respective custodians of the pooled funds, and on the responsibilities of the depositaries.

7. *Fourth recommendation: Breathe life into the management company passport.*

The FBF notices that the recommendation is not the result of a consensus inside the expert group. Nevertheless, the recommendation seems clearly encourage the implementation of a full European passport for the management companies.

Thus the FBF agrees the conclusions of the expert group, for the elimination of inconsistencies between regulations and the extension of the rights to manage funds on a remote basis is a key point of the development of the market. Naturally, the FBF estimates that the efficiency of such a passport depends on the level of trust existing between securities regulators. As a consequence the practices between them have to be harmonised.

Other items are fundamental, from FBF's point of view, to the efficiency of the passport of the management company:

- The removal of the distinction between contractual funds and funds in company form;
- The separation between funds and their management company;
- The clarification of the faculty for investment firms under the scope of the MiFID to manage investment funds;

8. *Fifth recommendation: Provide more freedom for the depositary.*

The recommendation is split in three proposals:

- enabling branches of banks from other Member states to act as a depositary;
- 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
- In a longer term, harmonise the capital requirements of depositaries and study the barriers to further harmonising the role and responsibilities of the depositary.

The FBF agrees with these proposals and underlines that the depositary passport needs, as a precondition, that the definition terms and responsibilities pertaining to the depositary function should be harmonised. From FBF's point of view there is no way to modify the UCITS III Directive without setting up the role and responsibilities of the depositary.

Furthermore, the custodian complying with the depositary's local regulations is essential to maintain the current level of investor protection in the absence of harmonised role and responsibilities of the depositaries.

Last but not least, the need of a clarification and harmonisation concerning the depositaries is essential to avoid regulatory competition.

FBF’S RESPONSE ON ALTERNATIVE INVESTMENT REPORT

9. The market share of hedge has considerably increased during the past few years. Thus it seems logical that the Commission analyses the best way to draw the future framework applicable to these funds.

10. Nevertheless, the FBF wishes to underline that the hedge funds market is still immature and that there is a great risk of overregulation which could be an obstacle to its development and to innovation by the industry. What appears on the hedge funds market is the need of flexibility. The attractiveness of this market depends essentially on its flexibility. A rigid regulation would be detrimental to this attractiveness.

11. Moreover, this market is an inter-professional market and the market participants are best placed to decide on what kind of products are to be created to develop the market.

12. What appears while reading the expert group report is that three steps have to be followed:

- The identification on non-legislative actions at national and EU levels
- The mutual recognition of retail oriented hedge funds products
- The absence of necessity of product regulation

13. The conclusions of the expert group report are summed up in the eleven following recommendations, which can be split in to categories:

⇒ **Retail-oriented recommendations**

1. Member States should recognise the broadening investor appetite for hedge funds and related products by developing a regulatory approach that is compatible with these needs and the organisation of the hedge fund business;
2. Reopening negotiations on the key provisions of the UCITS Directive with a view to facilitating the authorisation of a broad range of funds of hedge funds as UCITS;
3. Authorising UCITS to invest in derivatives on hedge fund indices;
4. Give effect to the mutual recognition of (nationally regulated) retail-oriented hedge fund products.

⇒ **Institutional-oriented recommendations**

5. Remove absolute or arbitrary quantitative restrictions on hedge fund based investing which are imposed on some institutional investors
6. Appropriate implementation of the Capital Requirements Directive and appropriate provisioning requirements under its forthcoming proposals for Solvency II;
7. Enter into negotiations with the US Securities & Exchange Commission and other relevant parties with a view to securing exemption from the US registration requirements for European hedge fund managers who are already registered with a Member State authority and are doing business with US qualified investors;
8. 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. This means the free choice of custodianship within the EU;
9. Monitoring of sub-custodians and harmonisation of requirements to be appointed as custodian;

10. Neither Member States nor the Commission impose any regulatory restrictions upon re-hypothecation limits for European hedge funds and that such matters be regarded as commercial terms of business to be negotiated between the fund and the prime broker;
11. Asset valuation standards in the EU should be based on the IOSCO report.

I. Retail-oriented recommendations

14. *First recommendation: Member States should recognise the broadening investor appetite for hedge funds and related products by developing a regulatory approach that is compatible with these needs and the organisation of the hedge fund business.*

This recommendation is split in two proposals:

- Introduction of a threshold of 50 000€ for retail investors investment, in order to prevent access to hedge by investors for whom such investments are not suitable;
- Implementation of a code de of conduct written by the industry in order to regulate the commercialisation.

The FBF agrees with these two conditions which are relevant to liberalise the access to hedge to retail investors without endanger the investors protection which is a great concern in France.

The FBF recalls on this matter that thresholds exist in France applying to the access of some kind of UCITS to retail investors:

- The “*Fonds communs d’intervention sur les marchés à terme – FCIMT*”. The regulation imposes a 10 thousands euros threshold of minimum subscription.
- The Collective investment schemes with streamlined investment rules. The regulation imposes, either a 125 thousands euros threshold of minimum subscription, or a 10 thousands euros threshold if the investor owns a 1 million euros portfolio invested in financial instruments.

15. *Second recommendation: Reopening negotiations on the key provisions of the UCITS Directive with a view to facilitating the authorisation of a broad range of funds of hedge funds as UCITS.*

It seems relevant that funds of hedge funds could be allowed such as funds of UCITS. It could be a good way to encourage the development of this market.

Nevertheless, from FBF’s point of view, any condition which could be implemented on this matter must not be a way for to set up new constraints on the production of individual hedge funds.

16. *Third recommendation: Authorising UCITS to invest in derivatives on hedge fund indices.*

From FBF’s point of view, the problem is less the faculty given to the UCITS to invest in derivatives in hedge funds than to authorise their commercialisation. Indeed, in France, UCITS may invest on derivatives but cannot be commercialised by ways of advertising and “démarchage”, although this market is not specifically dangerous for investors, for some thresholds have been set up to avoid that UCITS can invest their total assets in derivatives (leverage thresholds).

Thus the FBF is clearly in favour of the faculty given to the UCITS to invest on derivatives on hedge funds, and does not share the view of the expert group that there ought to be more

certainty on the reliability and functioning of hedge funds indices before UCITS investment on derivatives on hedge funds is authorised.

The FBF supports the allowance and wishes this idea will be developed in the future white paper.

17. *Fourth recommendation: Give effect to the mutual recognition of (nationally regulated) retail-oriented hedge fund products.*

The FBF has always considered the absence of European passport for UCITS or for management companies as an obstacle of the development and the integration of investment funds market in Europe. Therefore the FBF supports the principle of a mutual recognition of retail oriented hedge funds as a first step to the implementation of a full European passport.

Moreover, this mutual recognition would be a good way to improve the market environment of hedge funds in Europe.

II. Institutional-oriented recommendations

18. *Fifth recommendation: Remove absolute or arbitrary quantitative restrictions on hedge fund based investing which are imposed on some institutional investors.*

Whatever the market, whatever the instrument, FBF has always considered that the best way to protect investor states in the quality of the documentation and the information given to the investors.

Thus the FBF fully agrees with the proposal for the removal of any absolute or arbitrary quantitative restrictions. Beyond the principle, FBF underlines that institutional investors are the best placed to determine what kind of placement is relevant for their own clients.

19. *Sixth recommendation: Appropriate implementation of the Capital Requirements Directive and appropriate provisioning requirements under its forthcoming proposals for Solvency II.*

The FBF fully agrees with this recommendation, which can justify the removal of any quantitative restrictions on the investment made by institutional investors.

20. *Seventh recommendation: Enter into negotiations with the US Securities & Exchange Commission and other relevant parties with a view to securing exemption from the US registration requirements for European hedge fund managers who are already registered with a Member State authority and are doing business with US qualified investors.*

It seems indispensable to engage the dialog between the European Commission and CESR with the SEC. It is important that the European Hedge Funds can be commercialised in the USA without complying with every US registration requirements.

Nevertheless, the FBF will have a high attention on the rules which could be implemented in Europe, for the American rules applying to hedge funds are preliminary and restrictive and must not serve as a model for the future European framework.

21. *Eighth recommendation: 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. This means the free choice of custodianship within the EU.*

First, the FBF believes that clarification of the term Custodian used in the expert group’s report is needed. In particular, the functions and the responsibilities attached have to be précised. Indeed, custody services (asset safekeeping function) are generally offered by the Prime Broker, although the Depositary bank is often associated and confused in the term Custodian.

Thus the FBF will consider the term Custodian as Depositary.

Second, the FBF agrees with the recommendation, for the free choice of depositary within the EU is important for the development of the hedge funds. Nevertheless, as it was said about the “market efficiency expert group’s report”, the clarification of the role and the responsibilities of the depositary is a precondition. As this is not the case today, we believe that the depositary should be located and subject to the regulation of the country where the funds are distributed. This does not prevent in any case for the Prime Broker to be an entity located in another country.

22. *Ninth recommendation: Monitoring of sub-custodians and harmonisation of requirements to be appointed as custodian.*

The FBF agrees that harmonisation of requirements to be appointed as depositary is need. The FBF considers as relevant to set up a minimum assets test or a minimum credit rating to ensure that depositaries have a sufficient size and market standing to fulfil their obligations.

Naturally, such an approach needs a full harmonisation within the EU, in order to avoid discrimination between depositaries which won’t be compatible with the principle of the free choice of depositary.

The FBF also considers that monitoring of the sub-custodian network is an essential function. Nevertheless, clarifications are necessary: in practice Prime Broker, providing the custody services, are the entities that monitor and appoint the sub-custodians, although in some Member States the depositary remain responsible. The depositary however has no control on the sub-custodian network. The FBF agrees that the control of the sub-custodian network is important and that the depositary may have a role to play but it should also have the means to fulfil its obligations.

The FBF therefore recommends two options:

- The depositary retains only a general control function and the Prime broker is responsible for the fail of its sub-custodian, the prime broker being in charge of the monitoring of its sub-custodian network.

Or

- The depositary takes on some responsibilities in case of default of a sub-custodian, but in that case it should have a “veto” and /or a control right on the sub-custodian network and would be remunerated for the risk it takes.

The FBF does not believe that mirroring the custody positions of the Prime Broker in the books of the depositary is a solution that increases investor protection. It creates additional costs and increase operational risks (reconciliation issues).

23. Tenth recommendation: Neither Member States nor the Commission impose any regulatory restrictions upon re-hypothecation limits for European hedge funds and that such matters be regarded as commercial terms of business to be negotiated between the fund and the prime broker.

The FBF agrees with this recommendation. Moreover, the FBF shares the view of the expert group on the conditions of the implementations of such restrictions, if the Commission decided at the end to set up a framework on the re-hypothecation. These conditions are:

- The measure of the limit of re-hypothecation by reference to the level of indebtedness rather than by reference to the NAV of the fund. A prime broker can determine on any day how much the fund owes it but it cannot easily track the NAV because calculating this requires more information than is available to each prime broker, especially as most large funds now have more than one prime broker

And

- The necessity of coupling limitation on re-hypothecation with close-out netting provisions which would enable the setting off of the prime broker's redelivery obligation against the fund's liabilities to the prime broker

And

- The guaranty that each Member State recognises that a Prime Broker regulated in another Member State is entitled to provide prime brokerage services (for example, custody, clearing, stock and cash lending, and research) to hedge funds regulated within its territory

24. Eleventh recommendation: Asset valuation standards in the EU should be based on the IOSCO report

The FBF agrees with this recommendation, for a global approach is a better way than a pure European way to encourage the development of hedge funds market around the world.

As an example, the FBF believes that the pricing/valuation of complex instruments should remain the Asset Manager responsibilities. The Depositary as part of its control mandate could offer "counter valorisation " services that could be used as control tool for the Asset Manager and would increase investor protection.