HM TREASURY

UK AUTHORITIES' RESPONSE TO THE REPORTS OF THE EXPERT GROUPS ON INVESTMENT FUND MARKET EFFICIENCY AND ALTERNATIVE INVESTMENTS

In our response to the Green Paper on the Enhancement of the EU Framework for Investment Funds the UK Authorities (HM Treasury and the Financial Services Authority) supported the Commission's assessment that the priority for UCITS was evolution not revolution. This means protecting the progress towards a single market already achieved by avoiding wholesale change. In areas where there is a clear and pressing case for reform it is essential that sufficient work should be done to ensure that the benefits of any legislative solution outweigh the costs. We make the same point in respect of the Expert Group Report.

2. With that point firmly in mind, we have the following comments on the Report.

Alternative Investments

Private Placement and MiFID

3. In our response to the Green Paper, we emphasised the high priority we placed on the establishment of a common EU framework for private placement. A harmonised approach to private placement is important not only for the hedge fund and private equity sectors, but for the whole range of institutional fund management including for example institutional money market funds and property funds.

4. We maintain our strong support for harmonised private placement and welcome the support expressed for it in the report of the sub-group on private equity. We believe that it is vital that this work is carried out under the clear understanding that the aim is not to facilitate greater access to retail investors, but that the new freedoms should confine (or continue to confine) these funds to marketing to institutional and other qualified investors.

5. The first recommendation of the report of the sub-group on hedge funds is to prevent Member States from restricting the sale of unharmonised collective investment vehicles to the public – over and above regulating such sales through implementation of MiFID requirements. This rests on a controversial interpretation of MiFID, which we believe is not what the Council and the European Parliament set out to achieve with that Directive. We have set out separately to the Commission

our belief that MiFID does not prevent Member States from imposing restrictions on the marketing of unregulated funds. We do not believe that it is correct to suggest that MiFID leaves Member States with a choice between prohibiting the marketing of unregulated funds or potentially allowing them to be sold on an execution-only basis to retail clients.

6. Moreover, at a policy level, we do not believe that relying on MIFID alone would provide an adequate level of consumer protection in the sale of unregulated funds. We also believe that such an approach would seriously undermine the UCITS regime; it would seem unlikely that firms would go to the trouble to structure a product as a UCITS if they could easily sell unharmonised collective investment schemes both domestically and cross-border through MiFID. Thus we cannot support this recommendation. The best route to allowing greater cross-border freedoms to unregulated funds is not through the MiFID suitability and appropriateness regime but through the establishment of a cross-border private placement regime specifically designed for institutional investors.

Market efficiency

Notification

7. The Expert Group report calls for the existing notification process to be replaced with a regulator-to-regulator process, with an obligation on the home regulator to send notification to the host regulator within 3 days of a request from the firm, explicitly removing from the host state any right to vet the transmitted documents.[1] The UK response to the Green Paper suggested that the European Commission should consider legislative reform to the notification process only if the CESR work to simplify the notification process yields insufficient benefits. The CESR work has now been concluded and while improvements have been made, our view is that sufficient benefits are unlikely to be achieved. We therefore support the exploration of a simple regulator-to-regulator notification.

8. The aim of the UCITS directive was that home state authorisation should remove any need for a ‘second authorisation’ by the host state. Successful realisation of this vision is essential to the proper functioning of the UCITS passport and there is strong evidence to suggest that this has not yet been achieved.

9. We therefore support the expert group recommendation. Evidence so far is that a model under which regulators have even limited discretion to veto funds already authorised in other Member States does not in practice yield the appropriate level of single market freedom for funds. A radical simplification of notification such as this should hardwire in such freedom.

10. However, removing any right of veto from the host state would impact on the ability of host regulators to enforce the provisions under Articles 44(1) and 45 of the Directive to ensure that the marketing arrangements of the UCITS are compatible with host state legislation. Experience from the United Kingdom is that roughly 30

[1] Although it is not entirely clear in the report, we interpret this as removing from the host state any right to prevent the fund marketing its units including the existing right to veto due to deficient marketing procedures.

per cent of notifying funds have some regulatory deficiency in their UK marketing structure. The two-month period presently allowed by the Directive gives the FSA time to negotiate an acceptable solution with the incoming fund. If this two-month period were removed and the funds were to exercise their right to begin marketing immediately notification was received by the host regulator, any with non-compliant marketing structures would be subject to enforcement proceedings, potentially including fines. Consumer protection could be compromised as long as the non-compliant marketing went on.

11. Nonetheless, this cost must be weighed against the considerable benefit that such a radical simplification would bring to the UCITS industry, both in terms of reduction in the direct costs of notification and in the additional volumes of cross-border business it would undoubtedly facilitate.

Domestic authorisation

12. At the moment, the speed of home state fund authorisation is not subject to UCITS harmonisation, and we believe this issue is of secondary importance to the need to shorten the Notification process. The UK position requires authorisation to be given within six months, although in practice funds 75% of funds are authorised on average within six weeks.

13. The Expert Group calls for home states to authorise UCITS funds within 20 business days. The FSA's substantial experience of the authorisation process suggests that such a standard would lead to difficulties in completing the necessary checks in time. This is particularly likely to be the case where the product involved is an innovative UCITS III type. Furthermore we are not aware, in the UK at least, that the length of the initial authorisation process constitutes a significant problem for firms. However, if the case for further harmonisation of domestic authorisation can be made, we recommend setting a maximum period of two months for authorisations. This is on the understanding that the clock is stopped while (and only while) the competent authority is awaiting the UCITS' response to requests for information.

14. The Expert Group suggests that subsequent authorisation of new sub-funds should be effected within 10 days. We recommend a period of one month (with the clock stopping provision) as being consistent with our view above.

Mergers

15. We refer back to the comments in paragraphs 13 and 14 of our response to the Green Paper.

Pooling

16. We note the Expert Group's support for the idea of pooling. We support the group's recommendation that CESR should be asked to clarify issues around the operation of virtual pooling with the aim of facilitating it within the existing terms of the Directive. In addition to the list suggested we recommend that CESR should also examine how best to ensure compliance with the Directive's investment limits (e.g. Article 22).

17. Although we believe that virtual pooling would be an easier concept to reconcile with the Directive, we remain open-minded about entity pooling – we would require additional analysis on how such pooling would work in practice and how compliance with the investment limits in the Directive would be effected.

Management company passport

18. In our Green Paper response (paragraph 9) we set out our strong support for the instigation of functioning management company passport. We do not believe that concerns over split supervision or the lack of a substantial fund presence in the domicile represent insurmountable problems, but they do require further analysis. One solution may be for the supervisor in the home Member State of the management company to act as lead supervisor. The contract between the management company and the fund could make clear which State's rules would be applied to which aspects of the fund's operations.

19. In any case, any perceived difficulties around supervision must be weighed against the significant benefits which a properly functioning management company passport could bring, in particular reduction in cost flowing from greater centralisation and improvements in risk management from allowing this process to be located in the same place as the front office operation.

20. We believe that it should be possible to passport the full range of activities within collective portfolio management (including for example the calculation of net asset value).

Depositary passport

21. In our response to the Green Paper we suggested that this passport should receive a low priority, particularly in light of some significant, non-trivial issues concerning the differing nature of the depositary function in different Member States. In addition, we believe that the continuing presence of the depositary in the home Member State of the fund will provide helpful reassurance as we move towards effective implementation of the management company passport. We remain of the same view – see paragraphs 15-16 of our Green Paper response for further details. As long as there is to be no depositary passport, we also do not believe that harmonisation of depositary functions should be prioritised. Many of the differences flow from differing approaches to oversight in general so effective harmonisation would be a substantial task which we do not believe would yield commensurate benefits.

22. We do however support the idea of establishing greater consistency on what elements of the depositary function can be delegated cross border. The Commission should ask CESR to establish a common understanding on this. This work could be completed within the existing Directive framework. Successful completion of such work would also be helpful in further facilitating cross-border virtual pooling. We believe in general that depositaries should be allowed to delegate functions where there is no clear evidence that investor detriment would result.