

6 September 2006

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European Commission
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Dear Niall

Reports of the Expert Group on Investment Fund Market Efficiency and the Alternative Investment Expert Group

Please find attached the Investment Management Association's (IMA) comments to the expert groups' reports.¹ In our opinion the reports indicate clearly the necessary steps to overcome the existing barriers to cross-border business on asset management in Europe. They are an important step towards cutting costs and enhancing the efficiency of the European asset management industry.

The report on increasing efficiencies encompasses all of the focused, realistically achievable steps required to enhance the single market which were identified in IMA's 2003 report "Towards a Single European Market in Asset Management". Simplifying the UCITS registration process, facilitating cross-border mergers of funds, creating a real passport for management companies and allowing fund assets to be pooled cross-border, would go a long way to achieving the significant economies of scale highlighted by the Association three years ago.

The measures to enhance fund market efficiency should not be seen as something only benefiting the asset management industry. It is most important to stress that improving the efficiency of the industry should benefit the end-investors significantly. Lowering barriers for notification will increase the choice of funds in many Member

¹ The IMA represents the UK-based investment management industry. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of about £3 trillion of funds based in the UK, Europe and elsewhere, including authorized investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorized collective investment schemes.

States and will therefore enhance competition. Facilitating cross-border fund mergers, pooling and allowing a more streamlined organization of management companies through a real management company passport will bring significant cost savings to the industry.

The efficiency issues have now been analysed thoroughly and the report confirms that there is overwhelming consensus on what needs to be done. Now is the time for action to make these proposals reality. We therefore look at the Commission to take forward these four key initiatives as quickly as possible. They are all equally important to the European asset management industry as a whole, even if individual asset managers might prefer some initiatives before the others due to their chosen business model. In fact, moving forward with one rather than the other would benefit that particular business model.

As we have indicated in our earlier submissions, in the interests of acting sooner rather than later, we support the Commission in preferring non-legislative policy instruments. We recognize, however, that some of the expert group proposals are not susceptible to such initiatives, either because of constraints on what CESR members can or wish to do under domestic law or because the necessary mechanisms do not yet exist at EU level (e.g. on fund mergers). We therefore support any focused and targeted legislative initiatives that may be required. The Commission is the best judge to determine, on a case-by-case basis, whether legislative or non-legislative instruments will be required.

Those amendments to the UCITS Directive that are needed to implement the expert group's proposals should be done in Lamfalussy-format leaving room for comitology to deal with issues of technical detail that need to be adapted as markets develop. The focus of the Commission should be on quick delivery of these crucial and pragmatic key changes. The more philosophical question of re-writing the Directive as a whole to Lamfalussy-format should be left to a later stage.

The report on alternative investment funds is equally welcome, in particular the call to open up the markets for these kinds of investment funds. Currently, there are very different approaches to these types of funds in Member States and the report is likely to provoke very valuable discussion. Unlike on UCITS, on alternative funds there is no harmonised European framework. Member States have developed different national regimes, and determining the best common way forward is less easy. We expect to have yet more discussion and analysis on the actual proposals before final conclusions are made.

Please find our detailed comments on the issues raised in the expert groups' reports in the attachment. Please also note that the IMA has provided significant amount of data and argumentation on these issues in its input to the Commission's Green Paper consultation last November.² Those comments are still valid and we have not sought to repeat all of them in this response.

² <http://www.investmentuk.org/press/2005/20051116-02.pdf>

We stand willing and able to support the Commission and other policy makers in their work so please do not hesitate to contact me (snicoll@investmentuk.org) or my colleague Jarkko Syyrilä (jsyyrila@investmentuk.org) with any queries you may have on our submission or points you would like to follow up.

Yours sincerely

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IMA'S DETAILED COMMENTS

Report of the Expert Group on Investment Fund Market Efficiency

I Getting funds to the market more quickly

IMA strongly supports the expert group's proposals to reduce administrative delays in getting investment funds to the market. The notification process of UCITS has become a long, expensive and cumbersome administrative process in many Member States – the single greatest impediment to the efficient functioning of the UCITS passport in Europe. IMA and the European Fund and Asset Management Association (EFAMA) co-published a report on notification in April 2005, where the significant direct and indirect costs resulting from the malfunctioning of the notification regime were presented.³

The Commission and the European asset management industry originally put their faith in the national regulators to correct the situation within CESR. However, CESR's guidelines to simplify the notification process published last July fell short of the expectations of the asset management industry. The guidelines fail to facilitate a simplified and cost-efficient European regime for UCITS notification. Therefore the IMA now supports the Commission in taking legislative action to amend the UCITS Directive in this regard.

Especially crucial is the proposal regarding the role of the host State authority. We support the expert group's statement "the host State should not undertake any approval, vetting or administrative procedure relating to those documents". A major problem has been that many host States have challenged the UCITS passports of incoming foreign funds because of regulators' differing interpretations of the UCITS Directive. CESR has in its guidelines agreed this would not be the case in the future. To avoid any doubt, the host authorities' remit should be clarified in the Directive stressing the home state supervision principle.

We support moving to a regulator to regulator notification as has been used regarding credit institutions and investments firms, since the home State authority is generally in a better position to discuss and respond to the possible questions the host State authority might have than the UCITS manager. But it is then crucial that the both authorities operate in good co-operation and without any delay to facilitate quick access to the market, when there is a need to discuss a notification further.

We want to stress again the other key points we made in this regard in our response to the Green Paper. Host State authorities should be able to request only the information specified by the Directive (i.e. fund rules or instruments of incorporation, latest annual report, full and simplified prospectus, annual and half-yearly report). Since the home state regulator has already attested that information there should be no need for double checking. Where a local distributor is used to market UCITS, there should be no need to provide a detailed marketing plan beyond a statement to that effect.

³ <http://www.investmentuk.org/news/research/2005/topic/european/efamaima0405.pdf>

In our opinion notification should be required only for those sub-funds of an umbrella fund and those share classes of a fund/sub-fund which are intended to be marketed in the host State. A UCITS should be able to maintain its notification by merely filing any changes to its prospectus with the host state, without the need for further approval or delay.

In addition, the basis for charging *registration fees* should be harmonised and reduced. Current practice varies in relation to the regulatory fees charged for notification. Some Member States impose a fee per sub-fund of an umbrella fund while others charge set fees – which are sometimes the same and sometimes different - for a single fund and an umbrella fund. Regulators should also ensure that fees are not discriminatory, i.e. that there is no distinction on the basis of nationality of the fund.

IMA shares the view with all the other stakeholders on the failure of the *simplified prospectus* to deliver what it was supposed to be: a short and simple investor-friendly marketing tool to be used in all Member States. A good idea has turned out to be a total failure in practice. Therefore for the 'second try' a very careful analysis of what needs to be done is necessary. The Commission has initiated this work via workshops with the relevant stakeholders. The expert group's conclusions are an important input to the on-going debate. The questions to be solved relate to the format of the document, i.e. being user-friendly for the investors, flexible to update for the fund managers, and its legal nature, i.e. the liability issues should be solved allowing a simple and concise format for the document.

We support the expert group's proposal on the *language regime*. The host State authorities should only be able to require the simplified prospectus to be translated into the official, or one of the official, local languages for notification purposes. Experience suggests that the overwhelming majority of unit holders have little, if any, interest in the other documentation the Directive requires the UCITS to provide with the notification. Moreover, we believe that it is a commercial, rather than a regulatory, matter whether a UCITS provider deems these documents of interest to potential and existing unit holders and whether it elects to make further documentation available to such unit holders in the local language.

II Facilitating UCITS mergers

In IMA's view there is a clear economic case for providing a framework for fund mergers. Research consistently shows that UCITS exhibit economies of scale, i.e. total expenses ratios fall as funds under management increase. We therefore strongly support the expert group's proposals to amend the UCITS Directive and to put in place a separate Taxation of Fund Mergers Directive to facilitate cross-border fund mergers. The amendments should cover all legal forms of UCITS in Europe.

Since the legislative process will inevitably take its time, we urge the national regulators to hold bi- or multilateral discussions to facilitate mergers in the current regulatory framework as much as possible. CESR could usefully provide a platform for the multilateral discussions.

We fully share the view that one of the key prerequisites for a well-functioning European framework for cross-border fund mergers is to ensure the protection of investors in the merger process. We have some detailed comments in this regard on

the section A.iii concerning the apportion of the regulators' role. The report states that "Each regulator will obtain appropriate information regarding the merger concerning the fund in their jurisdiction that is subject to merge. Demands for information should not be materially different from what is required for a domestic fund merger."

We understand the need to give comfort regarding the merger to the regulator that "gives up" the fund, but we want to stress the need to have a harmonized set of information requirements. It would be very complicated if each jurisdiction applies their own information requirements to merger applications, and the wording used ('appropriate information') would leave the door open for possibly excessive, even protectionist requirements by regulators. Therefore the Commission should aim to harmonise these information requirements.

In our view further consideration should also be given to the proposal according to which the regulator of the fund that will not exist after the merger will approve the merger. To avoid excessive, even protectionist requirements by regulators in our view the Commission should aim to clarify the criteria based on which a regulator can disapprove a fund merger.

Regarding section A.vii, in many jurisdictions there is no requirement for a unit holder vote in relation to fund mergers, this is the case especially in contractual fund structures. In these cases the depositary of the fund and/ or the regulator have a role in ensuring that the interests of the investors are taken care of. We share the view of the expert group that there is no need to change this, it should be left to the local regulation whether a vote is required or not.

However, voting requirements can be a real barrier to fund mergers since some jurisdictions now effectively require a 100% unit holder approval, which is almost impossible to reach in practice. Therefore, the IMA strongly supports the proposal that where voting is required by local law, quorums and/ or thresholds should not be overly onerous and in no case should the approval requirement be more than 75% of those voting. The calculation of this limit should indeed be based on the proportion of votes cast rather than the proportion of votes eligible to be cast since the participation rates in these kind of votes can be rather low. It would also be useful to harmonize the voting practices in jurisdictions where voting is required.

III Allowing pooling techniques

IMA strongly supports the expert group's proposals to facilitate the use of pooling techniques. We believe the economic case for pooling the assets of UCITS is similar to that of mergers, i.e. that pooling enables investment managers to realize economies of scale. It is generally more cost efficient to manage one large pool of assets than many small pots. Investment managers, therefore, have a prima facie interest in pooling, as do their customers – after all, that is one of the reasons why retail investors pool their savings in UCITS. Investment managers are often unable to pool the assets of the UCITS or pension schemes that they manage on a cross-border basis. We believe this is a significant impediment to the efficiency of the single market. Consequently, the IMA published a detailed report on pooling in July 2005.⁴

⁴ <http://www.investmentuk.org/news/research/2005/topic/european/pooling0705.pdf>

We want especially to stress that pooling is not a substitute for mergers. Both are necessary measures to increase the cost-efficiency of the European investment funds and to enable managers to pursue the strategy and business model which is best for them. Pooling mechanisms are especially relevant when the asset manager considers it necessary to have locally domiciled products for tax or some other reasons.

The IMA supports targeted amendments to the UCITS Directive to allow for the so-called entity pooling. As the expert group suggested, regarding virtual pooling an active role should be given to CESR, to share experiences among regulators on the current regulatory practices on pooling, to study the barriers in the practices in different jurisdictions, and to find solutions to the issues raised.

The IMA also supports the expert group's proposals concerning pooling of the assets of pension schemes.

IV Making the management company passport work

IMA strongly supports the creation of a proper management company passport, which would enable asset managers to avoid duplication of organizations and save costs by operating a single management company in one Member State and passporting its services elsewhere. It has been very frustrating to the European asset management industry that the UCITS III changes only succeeded to create a passport for management companies on paper and not in real life. UCITS III also imposed more onerous requirements on management companies than before, therefore increasing significantly the cost of operating several ranges of funds around Europe.

In IMA's view the aim should be the ability for a management company to establish and manage a UCITS constituted in another Member State, regardless of the legal structure of the UCITS. The expert group's proposals bring lot of clarity on what should be done to make the management company passport a reality. The IMA supports these proposals.

We note that there were differences of opinion in the expert group regarding the scope of activities covered by the passport. The IMA is of the view that the aim should be as wide a scope as possible, to give a real content to the passport. We believe that the questions regarding appropriate supervision can be solved. As we explained in our response to the Green Paper, there are several elements for solving this issue including enhanced supervisory co-operation, which is anyway a reality through CESR, a contractual arrangement between the fund and its management company on the applicable law/regulation, and especially the key role of the depositary. We believe the existence of the fund and its depositary in the same Member State is a crucial element making the management company passport possible. We accept that the depositary should be regulated in the same Member State as the UCITS which it oversees, because the depositary, in some sense, 'stands in' for the regulator of the UCITS. We therefore believe that whilst a UCITS and its depositary should be subject to unitary regulation, this is not true of the management company.

V The depositary

In the short term the expert group recommended allowing branches of EU established banks to act as depositary for locally domiciled funds and allowing delegation of custodial function to licensed custodians located elsewhere in the EU. We support facilitating cross-border delegation and/or sub-custody arrangements. We understand, for example, that in some Member States regulations require a UCITS' underlying portfolio of securities to be held directly by its appointed local custodian which has the effect of restricting a UCITS ability to appoint a "global subcustodian" or "regional subcustodian". We believe such restrictions are anti-competitive and could usefully be removed. Furthermore, this would assist in the cross-border virtual pooling of UCITS' assets. In IMA's view CESR could usefully survey its members' attitude to delegation by depositaries and the appointment of global sub-custodians, with a view to issuing Level 3 guidance.

In the long term the expert group recommended the harmonization of the capital requirements for depositaries and more broadly of the status of the depositary, as being "necessary in order to support the sound management of risks and continued investor confidence."

IMA does not believe that the economic or regulatory case for a depositary passport has been made. The single market for depositary services appears to be functioning well at the moment on the basis of the freedom of establishment, i.e. most major depositary firms have established a presence in the main exporting states (Luxembourg and Ireland) and certain other states with large numbers of domestic UCITS (the UK, Germany, France etc). Depositaries are therefore already in competition with one another throughout the EU, through their local establishments. Evidence for the effectiveness of this competition can be seen in the relatively low fees charged for depositary services. So, there is little to be gained by providing a further freedom to passport those services cross-border. Neither do we believe that there is a consumer protection case for harmonising the 'oversight' and 'safekeeping' functions of a depositary (which would be a necessary precursor to passporting those services). Despite the fact that these functions are differently defined by Member States, when IOSCO reported on the different fund governance models practiced throughout the world, it found no evidence that any one is better than the others.

Report of the Alternative Investment Expert Group

The IMA's main interests regarding this report relate to the distribution issues, therefore we provide comments only regarding this part of the report. We want to stress that our members' interests on European distribution of non-harmonised funds do not only limit to hedge funds, and therefore the expert group's report on hedge funds should not direct all the attention of the Commission solely on hedge funds. For example property funds are an important asset class outside the UCITS Directive.

We fully agree with the expert group's conclusion that no harmonized European product regulation should be developed for hedge funds since a key element of their nature is their ability to take advantage of new instruments and financial innovations. An attempt to harmonise the investment and borrowing powers of these innovative and fast changing funds would necessarily become quickly outdated.

While we are satisfied with that the expert group has taken a strong view in favour of opening up the markets for hedge funds in Europe and we support exploring the opportunities this might create, we feel there is no certainty that the group's view that such funds need only be subject to MiFID suitability and appropriateness tests and cannot be subject to further restrictions on distribution will prevail. The diverging views on this issue were clearly presented in the Commission open hearing on 19th July. We ask the Commission to provide clarity on the issue of the impacts of the MiFID regime on the marketing of non-harmonised funds: the worst scenario in our view is ambiguity and diverging interpretations in different Member States.

Whatever the result of the discussion on the effects of MiFID to the cross-border distribution on non-harmonised funds, we want to stress as we did in our Green Paper response, a need for a harmonised European private placement regime. Existing domestic private placement regimes are highly fragmented. They all make different legal demands, and consequently represent a complex barrier to business. This distorts competition by favouring domestic incumbents rather than those seeking to provide services across EU borders. We therefore believe that harmonising private placement rules should be a priority. A harmonised approach to private placement is important not only for the hedge fund sector, but for the whole range of institutional fund management including for example institutional money market funds and property funds. We call for the establishment of a cross-border private placement regime specifically designed for institutional and other qualified investors.

We agree with the expert group's recommendation that it is important to remove the barriers existing in many Member States that restrict institutional investors from alternative investments without being grounded in any coherent regulatory or prudential considerations. We also want to stress that any changes considered towards a pan-European regime must not impose more restrictions than exist at the moment: institutional investors should be free to buy non-harmonised funds – the question is over the extent to which they should be available to retail investors.