

# Expert Working Group on Alternative Investment Funds: Terms of Reference

## 1. Background

**The European market for UCITS<sup>1</sup> (funds which are harmonised at EU level) has grown rapidly in the last decade.** Since 1994, assets under management have experienced a nearly four-fold increase and the number of funds has multiplied by nearly three times. This represents a considerable success in the creation and development of a pan European retail investment product. In June 2005, assets managed by UCITS amounted to €4.7 trillion or some 75% of the assets under management by the whole European investment fund industry.

**However, the segment of the funds market which still falls outside the scope of the current framework is growing rapidly.** The average size of the non harmonised market has nearly doubled during the 1993-2003 period; (probably) reflecting the growing interest of investors (especially institutional entities) in diversifying their portfolios.

**The non-harmonised sector (i.e. non-UCITS) accounts for around €1.3<sup>2</sup> trillion** assets under management (and growing...). Non-harmonised funds include c. €900 billion in quasi-UCITS, including c. €150 billion in real estate funds; c. €250 billion in Hedge Funds; c. €150 billion in Private Equity funds

**Hedge funds and private equity funds were excluded from the scope of the 1985 UCITS directive.** These industries offer new diversification benefits for asset managers, the promise of higher returns for investors, increased market liquidity and they can contribute to the Lisbon objective of creating a competitive and dynamic economy. While not subject to EU legislation, Private Equity Funds & Hedge Funds are often subject to national regulatory regimes or divergent national rules on their offer/placement. In order to remain internationally competitive, European based Hedge Funds and Private Equity funds require a regulatory environment which will respect their innovative strategies.

**So far the Commission has seen no demonstrable case suggesting that there are significant European risks/Single Market failures** for Private Equity funds and Hedge Funds which require a Community level response. Existing national regimes may offer the necessary protections for concerns that arise at local level. **However, Divergent national regimes carry the risk of regulatory fragmentation.** There is a hypothetical/perceived risk that this patchwork could have a negative impact on the development of these businesses on a cross border basis.

**This Group will document any obstacles to the smooth development of the Hedge Fund and Private Equity fund business on a cross border basis** and will assess whether there is any material advantage to trying to resolve problems of EU regulatory fragmentation? Does this regulatory patchwork give rise to real – as opposed to theoretical problems – to promoting non-harmonised funds or raising capital in other European jurisdictions?

The mandate of the expert group will be to produce a report on each of these two alternative investment fund markets summarising the key recommendations.

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<sup>1</sup> UCITS : Undertakings for Collective Investments in Transferable Securities

<sup>2</sup> 2004, during 2005 is has been estimated to have grown to €1.63 trillion assets under management

## 2. Mandate for the expert group

### 2.1 Scope

This Expert Group will focus on Hedge funds and Private Equity (including Venture Capital) funds (and related fund of fund structures).

The business models, market conditions and regulatory treatment of these two segments differ widely. Each of the two segments will be separately assessed and reported upon.

There can be no common analysis of barriers to pan-European development of these businesses and possible solutions. Nevertheless, there may be some interesting similarities (such as in the area of distribution), or examples of common problems (such as definitions of private placement) where the potential for cross-product consistency could be explored in further detail.

### 2.2 Objective

The objective of the Expert Group will be to advise the Commission on matters relating to the European market for Hedge Funds and Private Equity funds, and in doing so:

i) as regards the evolving landscape for alternative investment management

**Describe and analyse current trends and issues** in terms of: a) product development, financial innovation and structuring, and managing portfolios; b) cross border distribution/marketing/offer of funds; c) customer base (including the extent of retail investors' exposure to alternative investments); as well as the reasons that have led to these features;

ii) as regards doing business within the existing framework

**Identify, describe and document the** legal, organisational, regulatory, and administrative and other **barriers hindering the efficient development** of the Hedge Fund and Private Equity fund markets on a cross-border basis. This would include, but not be limited to, barriers encountered at various stages along the investment fund value chain:

- Product manufacture, registration and notification
- Fund distribution, offer and marketing, market access
- Fund management, administration and safekeeping

Reflect on how the value-chain for these activities is organised across the EU and whether there are features of national tax systems or regulation which stand in the way of development of a business model capable of raising capital/ managing or administering funds/reaching investors on a cross-border basis, and whether these features are motivated by legitimate concerns;

iii) as regards practical solutions to existing problems

Propose solutions [where possible] that could be most helpful in overcoming the cross-border barriers identified by the Group. Test – in broad-brush terms – different options for overcoming those barriers against considerations of cost-effectiveness – also taking into account the possible impact on operators who are not active in cross-border markets. This latter work could include consideration of whether a common understanding of “private placement” could facilitate cross-border offer of non harmonised funds aimed only at professional investors.

The group's recommendations would aim to distinguish between: 1) optimal practical solutions to the removal of barriers to the Single Market; and 2) realistic solutions that are still worth pursuing even in cases where existing and foreseeable constraints in Member States cannot be removed in the short to medium term. In so far as any proposed solutions relate to identified trends and issues which may impact on the industry's customer base, the Group should give due consideration to any relevant investor protection concerns.

## 2.3 Output

The Expert Group shall produce two reports which will be made public as a basis for discussion with Member State authorities, EU bodies and other stakeholders. These reports shall separately address the Hedge Funds and Private Equity funds, and will reflect the consensus view of members of the individual sub-groups.

The reports will not be considered as reflecting the views of the organisations which nominate the expert group members. Nor shall it be considered as reflecting the views of the Commission services.

## 2.4 Indicative analytical framework

The following box provides an indicative analytical framework for the work of the group.

- 1. Description of drivers or change and of the industry (segment) landscape over next 5-10 years:** Discussion of how the asset class in question is evolving; views on where the industry is likely to be in 5 years time; and areas of current friction. This description should clearly describe for the main Member State markets the range of investment propositions available in each segment at the moment; the investor base for which such products are destined/suitable;
- 2. Optimal outcomes in terms of organisation of the business model on a cross-border basis:** description of the desired state of market including reflection on how commercial or geographical opportunities could be best exploited at the key stages of the value-chain.
- 3. Mapping main policy or structural barriers to cross-border business development:** A core component of the assessment will be to provide an authoritative and comprehensive description of any features of the commercial, tax or regulatory landscape prevent the realisation of desired outcomes. This mapping should clearly distinguish between obstacles developing key aspects of the business on a cross-border basis which have their origin in market structures, tax considerations, regulatory barriers and/or other (contract law).
- 4. Option identification and assessment:** To the extent that obstacles standing in the way of cross-border developments are identified, the analysis should assess the need for and possible form of EU level action. This will include consideration of whether policy action at EU level is the best way to solve the problem; for example to counteract Single Market fragmentation or cross-border risk. Different options for realising objectives could be considered
- 5. Detailed assessment of policy steps.** Identification + analysis of available policy options < Supported by analysis of impact on markets and investment flows; innovation; direct and indirect costs for business.

### **3. Practical modalities for composition and operation**

#### **3.1 Composition**

The Group will comprise a maximum of 25 experts. The members of the group shall be appointed by the Commission on the basis of proposals from trade associations (hereafter, just "associations") representing the interests of all or part of the EU Hedge Fund and/or Private Equity fund industry.

#### **3.2 Expert Group organisational structure**

In view of the differences between Private Equity funds and Hedge funds, the Group will be split into two streams. Both streams will be involved in the initial session(s) to help map the future landscape for non-UCITS/alternative investments, and to agree a common frame of reference. The streams will then separate and produce independent reports.

To ensure cross-product consistency; areas of particular concern, key risks and potential overlaps etc., the streams will be updated by the secretary of the other subgroup on a regular basis. There is no presumption that streams' views will converge as a result of this inter-group briefing.

#### **3.3 Operation**

The Commission shall Chair the group including (both streams). The Commission shall provide secretarial services. The group shall adopt its rules of procedure on the basis of the standard rules of procedure adopted by the Commission. The Group shall adopt its opinions or reports by consensus.

In agreement with the Commission, sub-groups may be set up to examine specific questions under these terms of reference; they shall be disbanded as soon as these have been fulfilled. Sub-groups will appoint a "facilitator" that will, in collaboration with the Commission representative(s), chair the sub-group's debates.

The Commission may ask experts or observers with specific competence on a subject on the agenda to participate in the group's or sub-group's deliberations if this is useful and/or necessary. The Commission will, in particular, invite observer(s) from consumers/investors associations. Other Commission officials with an interest in the proceedings may attend these meetings.

Members of the Group will remain in office until such time as the final report is finalised. Members who are (or are deemed to be) no longer able to contribute effectively to the Group's deliberations may be replaced for the remaining period of their mandate. The above mentioned selection criteria should be respected when nominating new members.

Information obtained by participating in the group's or sub-group's deliberations may not be divulged where the Commission lays down that this relates to confidential matters.

The Commission may publish on the DG Internal Market and Services website, after consultation with the group, in the original language of the document concerned, any résumé, conclusion, or partial conclusion or working document of the group.

### **3.4 Call for expressions of interest from trade associations and representative bodies:**

Upon adoption of the Commission decision to create the Group, the Commission services will publish a call for expressions of interest from interested trade associations (hereafter, "associations") which can mobilise relevant expertise in respect of the issues governed by these terms of reference. Associations wishing to propose experts to the Group are asked to express their interest in the form of a written correspondence, to be posted to the Commission not later than 30 December 2005. The expression of interest must be accompanied by the list of prospective experts which the association wishes to put forward for consideration as possible members. The submission must therefore include relevant information to allow the Commission to assess the suitability/expertise of the proposed individual expert having reference to the criteria set out below.

Associations must represent the interests of all or part of the EU investment fund industry. These associations should have a pan-European scope or at least cover a representative number of Member States. Priority will be given to experts proposed by associations having a pan-European dimension. However, national associations representing the interest of a particular function/actor (administration, management, custody, distribution etc.) within the Hedge Fund or Private Equity fund industry value-chain could be invited to designate an expert if such a function/actor is not adequately represented at a pan-European level. The Commission shall also have to ensure that the interests and situation of small, locally-oriented operators are reflected in the composition of the expert groups.

Each tendering association is free to propose the number and of experts that it considers appropriate in view of its scope of activities, membership, and the number functions within the industry value-chain covered.

#### ***Criteria governing the selection of experts:***

- The experts proposed by each association must have recent, direct professional expertise in respect of the issues covered by these terms of reference. In particular, proposed experts should have relevant direct experience – from an earnings-generating and/or cost-management capacity – in business projects or matters which equip them with commercial or technical insights needed to develop solutions to the issues raised by this terms of reference.
- Proposed experts should also play a key role in shaping the views of their parent organisation or sponsoring association in respect of these matters.

Individual proposals should therefore be accompanied by material demonstrating that the expert put forward meets the above conditions.

Individual experts shall also be proficient in a language which is customary in the sphere of finance, at a level which allows them to contribute to discussions and report drafting in that language.

### **3.5 Final determination of group composition**

The Commission shall decide upon the final composition of the group on the basis of eligible proposals submitted by associations which respond to the call for the expressions of interest.

The Commission shall select the proposed experts who best embody the required commercial and technical expertise in respect of the matters covered by the mandate for the expert group, as evidenced by prior experience in proposing or implementing solutions to these problems within their parent organisation or sponsoring association.

The Commission will also seek to ensure that the group composition spans the range of relevant functions within the industry value-chain given the issues raised by these terms of reference. The Commission will also wish to ensure an appropriate multi-disciplinary mix within the group.

In making the final selection of group members based on the basis of submitted proposals, the Commission shall be guided by the need to ensure that, in addition to covering all main areas of expertise, the Group has, to the greatest extent possible, a balanced geographical and gender composition. Geographical representation shall mean ensuring a fair spread of experts, taking account of the distribution of the relevant activities, and relevant commercial experience, across the Single Market.

However, the over-riding criterion will always be the extent to which individual experts have a track-record in dealing with commercial projects or problems of the type arising from this mandate.

Once the Commission services have arrived at a definitive selection of group members, they shall advise all sponsoring associations of their decision. The list of expert group members shall be made public on DG Internal Market and Services website prior to the commencement of its work.

### **3.6 Duration and location**

The Group's activities will begin early 2006. The Group is established for 6 months. The Commission may extend this period if considered necessary to complete the Group's work.

Four to five plenary meetings will take place in Brussels on the Commission premises in accordance with the procedures and schedule established by it.

Discussions may also be held via other communication means such as conference calls and/or e-mail exchanges, if the Group deems necessary.

### **3.7 Expenses of group members:**

The Commission shall reimburse travel and subsistence expenses for its members in connection with the group's activities in accordance with the provisions in force at the Commission. The members shall not be paid for their duties.