Overview of the report of the Expert Group on Investment Fund Market Efficiency

This overview has been prepared by Commission services. Readers are invited to refer to the Executive Summary of the report and to the full report.

A successful industry…

The UCITS model has clearly been a successful launching pad for the EU fund industry. The market has quadrupled in size over the past decade, to more than 30,000 UCITS with € 5 trillion in assets under management at the end of 2005. Integration is deepening as net sales of cross-border funds have been outpacing sales of domestic funds over the past few years.

The UCITS regulatory concept has become the de facto international gold standard. Regulatory and investor confidence in UCITS stem from the protections that are built into the Directive.

… facing important challenges …

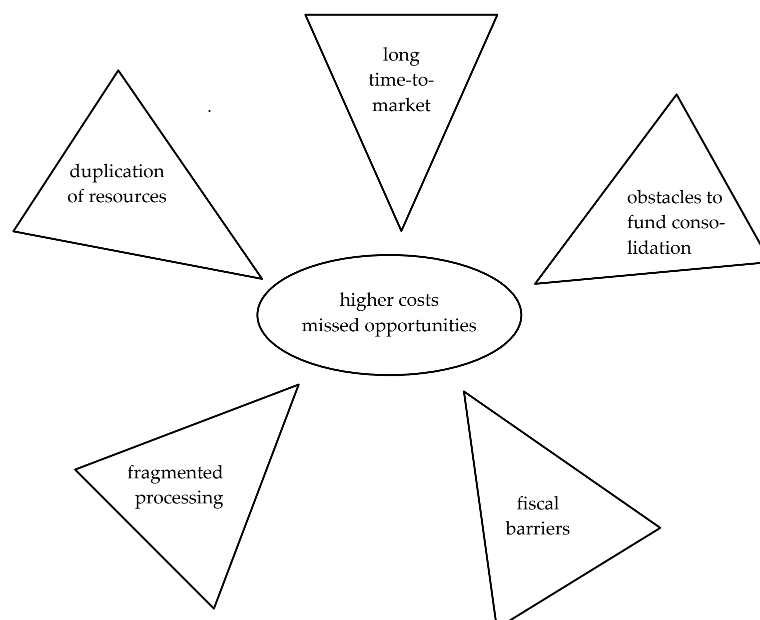
However, a rapidly changing environment is placing strain on the UCITS framework. The demand for investment products has rapidly evolved in response to structural trends, such as the ageing of the population. At the same time, retail investors tend to have a more sophisticated understanding of the investment products on offer. Finally, uneven disclosures and conduct of business protections put the fund industry on an unequal footing compared to other financial services.

UCITS must respond quickly to these pressures if they are to remain competitive and attractive to investors. Should this not be the case, other investment products will rapidly fill the gap.

… but poorly equipped to cope with them.

The Expert Group has identified a limited number of inefficiencies that are stunting the investment fund industry's development. Removing these is urgently needed in order to allow the fund industry to provide efficient and effective investment solutions for European investors.

The Expert Group has identified 5 sources of inefficiencies:



Improvements are urgently needed in order to :

Reduce administrative delays in getting investment funds to the market

The Group recommends:

- amending the UCITS Directive to align its authorisation and notification rules along Prospectus Directive timescales, meaning authorisation of funds in 20 business days and electronic regulator-to-regulator notification taking a maximum 3 days.
- revising the simplified prospectus so that it becomes a fully and automatically recognised document containing key disclosures for investors. The simplified prospectus (including any translations thereof) should be communicated as part of the cross-border notification and should not be the subject of further examination by the host authority.

Enable the rapid and efficient merger of funds

The Group recommends:

- expanding the UCITS Directive to include arrangements for fund mergers to take place, subject to safeguards that protect investor interests and enjoy supervisory confidence;
- taking actions to ensure that fund mergers do not give rise to adverse tax implications.

Allow the centralised (pooled) management of assets owned by different funds

The Group recommends:

- removing provisions of the UCITS Directive that preclude master-feeder and other forms of entity pooling;
- building an understanding between regulators in order to allow the wider application of virtual pooling techniques;
- allowing the depositary to appoint a custodian based in another EU State.

Breathe life into the management company passport

The Group recommends:

- eliminating the inconsistencies and omissions that have robbed the management company passport of its effect;
- extending the right to manage funds on a remote basis to all types of funds;
- removing the "head office" principle or replacing it with a "key activities" or similar concept;
- providing clarity on the activities and services which the management company can provide on a cross-border basis.

Provide more freedoms for the depositary:

The Group recommends:

- enabling branches of banks from other Member States to act as a depositary;
- allowing the depositary 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, 1) harmonise the capital requirements of depositaries and 2) study the barriers to further harmonising the role and responsibilities of the depositary.

Overview of the report of the Expert Group on Private Equity

This overview has been prepared by Commission services. Readers are invited to refer to the Executive Summary of the report and to the full report.

The report of the private equity Group explains why private equity is important and how it is different from other types of investing. It highlights its particular contribution to increasing European competitiveness and commercialising innovation; to strengthening company governance and management; and to preparing companies for further growth and public offer.

The private equity industry has a proven track record in increasing productivity and profitability and at the same time creating jobs. A successful private equity industry can make an important contribution to the re-generation of the economy by nurturing new enterprises and re-energising existing companies. In so doing, it can lay the seeds for sustained growth and job-creation and assist in the drive to be increasingly globally competitive. If the EU is to harness this potential, there will be a need for a greater understanding in many Member States and at the EU level of the way in which the private equity industry is organised and carries out its business.

The private equity industry has developed successfully on the basis of relationships between sophisticated actors which have been constructed in accordance with privately negotiated agreements undertaken between fund managers and their "professional" investors. The industry adheres to self imposed industry standards which have been created in conjunction with investors/clients. The current mix of self-regulation and light-touch supervisory oversight remains a viable basis for the continued development of the industry and its business model. The institutional nature of the investor base is an important reason. This explains why this asset class does not need intrusive regulatory involvement in the conduct of business and management of assets.

Most Member States regulate part or all of the private equity value chain. However, Europe's national regimes do not interlink and are heavily fragmented. They make little concession to the growing cross-border or international dimension of the private equity industry. Actors are more inward-looking than would be expected in a true single market. There is a broad understanding that cross border investments could be far more significant if funds did not encounter substantial administrative burdens and restrictions to cross border investment or capital raising. The industry wants to be able to invest in EU projects on a cross border basis in the same way as other financial transactions (public equity investments).

This report explores the principal barriers to the development of the industry on a European wide basis. It argues that further integration of the EU market would allow the private equity business to play its full role in supporting entrepreneurship and corporate regeneration. It builds a case for proportionate change based on the concepts of mutual recognition of existing national laws and a consistent approach to European issues.

The Group calls on Member States to take a consistent and light touch approach to implementation of EU laws that affect the private equity industry and not introduce obstacles to professional investors accessing private equity funds. At European level, as at national level, policy-makers need to be more cognisant of the specific characteristics of the private equity industry. This is not a case of special pleading. It is a case of policy-makers taking the time and care to ensure that cross-cutting financial and company law do not generate unintended consequences for the unique business models that underpin Europe's private equity industry.

The report is not a call for legislative action to align national practices. The private equity industry has shown that it is a responsible participant in the financial system. It remains clearly focussed on the needs of its essentially professional investor base. The current mix of self-regulation and nationally-based operating conditions remains appropriate. There is no need to superimpose European harmonising measures on the industry. What is needed, however, is for national authorities to recognise that partner country private equity managers and arrangers operating in their territory are already subject to tax and regulatory regimes in their home country. On this basis, we should look to free the industry from punitive double taxation and legal uncertainty that currently hold back the onshore activities – to the advantage of offshore structures. It has proved possible to put these conditions in place for other segments of the financial services industry.

Private equity fund structuring:

The efficiency of the EU private equity industry suffers from an overly complex and ill suited fund structuring environment which does not support cross border investing. This is particularly problematic for smaller venture capital and buy-out funds, especially those players operating in smaller and less developed markets. The guiding principle for enlightened and single-market-compatible taxation of private equity funds is that the investor only be taxed in its home country on capital gains. The Group recommends that for tax purposes Member States treat investments in vehicles that are used to pool assets invested in private equity investment programmes in the same way as they treat public equity investments.

Cross-border placement of private equity funds:

The Group would also encourage the Commission and Member States to consider a number of steps that could improve the situation for EU private equity managers seeking to sell their products in other Member States. What is needed is a common understanding of what constitutes private placement; who this may apply to; and how one may qualify for such treatment. The basic premise of a private placement regime is that regulation should not encroach on negotiated relationships between private entities, where the contracting parties are capable of understanding the nature of the bargain, including any attendant risks. The Expert Group recommends that EU institutions and Member States consider establishing a common understanding of the parameters of "private placement". This could involve building on, with adaptation in relation to experience/dealing frequency, useful provisions of existing Community law as regards the notion of "qualified investors" who can be approached without triggering mandatory disclosure or conduct of business rules.

Overview of the report of the Expert Group on Hedge Funds

This overview has been prepared by Commission services. Readers are invited to refer to the Executive Summary of the report and to the full report.

This is the first time in Europe that hedge fund practitioners report to policy makers to explain how they see the future development of the hedge fund industry in the European context. This report tries to address preconceived notions about the hedge funds, explain how they see the challenges and identify areas for possible improvement in the European Union.

Addressing erroneous reporting or misconceptions about hedge funds:

Hedge funds can be best described by their main characteristic: they are more flexible in terms of investment options or strategies than traditional collective investments. Their nature is international: funds or products domiciled in one jurisdiction are managed and serviced from another, for sale to clients in a third. The main driver of the success of hedge funds is the recognition of their benefits to the financial system by providing risk diversification and to individual portfolios by providing positive and less volatile returns. Hedge funds importantly contribute to (and actively benefit from) financial innovation.

There are many misconceptions about hedge funds. The Group wished to set the record straight. Hedge funds are not especially prone to fraud or market abuse. Hedge funds are no longer the preserve of super-rich and risk oriented investors. Recent years have been characterised by increased investment from institutional investors. Institutionalisation of this industry is driving increased transparency, better valuations and risk management. There is little evidence to suggest that hedge funds significantly threaten financial stability.

Identifying the obstacles which hold back the efficient organisation of the business in Europe:

The European Union is at the heart of this growing business. European hedge fund managers now manage $325 billion. Their customer base is broadening. Pension funds, life insurance companies and other institutional investors increasingly understand that there is a place for hedge funds in a properly diversified portfolio. Many Member States have taken regulatory initiatives in this field. The Group appreciates that public authorities have a legitimate interest in the activities of hedge funds – particularly to the extent that certain hedge fund products are sold to the retail market.

However, the regulatory patchwork in the European Union limits the most efficient organisation and distribution of the hedge fund business. In particular, there is continued uncertainty regarding the conditions under which distribution can be undertaken which prevents the development of a scalable onshore business. Regulatory patchwork results also in inefficiencies in providing support services to the hedge fund industry. Therefore, the Group believes that, if the European Union wishes to be home to a successful hedge fund business, it should take steps to remove these frictions.

Proposing targeted adjustments to European and national environment:

The Group has agreed a set of targeted adjustments which would facilitate the further successful development of this business in Europe without compromising regulatory objectives of retail investor protection or market integrity. The report presents eleven recommendations (fully listed in the Annex 3 to the Group report) related to two key issues:

1. **Freeing up access to by removing unproductive, inefficient and unjustified legal or regulatory impediments:**

The hedge fund industry wishes to service qualified investors (who are capable of self-directed investment) in other Member States as efficiently as possible. The Group recommends that regulators do not seek to control distribution through product regulation or registration or arbitrary quantitative restrictions but focus, instead, on two levels of protection: 1) a minimum threshold of 50'000€ would prevent access to hedge funds by investors for whom such investments are not suitable; and 2) enforcing clear conduct of business requirements on the distributors under the MiFID provisions would provide graduated level of protections required by different investor categories.

The Group calls for a rational debate on the conditions under which retail access to hedge fund-based investments could be contemplated. However, it considered inappropriate to broaden the provisions of the UCITS Directive to allow funds of hedge funds to be authorised as UCITS compliant funds. In, addition, concerns regarding the reliability and functioning of hedge fund indices have to be resolved before authorising UCITS to invest in derivatives on hedge fund indices. Whilst concerned about the limitations associated with product regulation, the Group believes that nationally regulated hedge fund products should be mutually recognised as suitable for sale to the investing retail public across Europe.

2. Creating a single market for hedge fund essential support services such as fund administration, custody and prime brokerage:

Due to the regulatory fragmentation as regards rules governing service providers for hedge funds, European hedge funds are currently not always able to choose service or liquidity providers from across Europe. However, custodians and prime brokers are established in highly regulated European jurisdictions.

In light of the intended harmonising effect of MiFID, the Group recommends that European hedge funds may appoint a custodian subject to a minimum assets or credit rating requirement, either domestically or in another Member State. This custodian should not bear full liability for asset restitution but should be obliged to act reasonably and take due care and skill in monitoring the sub-custodian network. The Group recommends that limits upon re-use of assets that a prime broker get as collateral should be regarded as commercial terms between the fund and the prime broker.

As regards asset valuation, considering the global nature of hedge fund operation and the active participation of most Member State regulators in the IOSCO Standing Committee n° 5, the Group does not wish to pre-empt the IOSCO report and make specific recommendations at this time.

No need for specific legislation:

The main message of the Group is that hedge fund business is maturing in a way that does not call for additional specific legislation of hedge fund participants or investment strategies at a European level. The Group's eleven recommendations should not be viewed as a pretext for heavy regulatory involvement in this business. Implementation of these recommendations does not, in the Group's view, require extensive legislative harmonisation. Any regulatory evolution as regards hedge funds should be a proportionate response to demonstrable risks and take account of the specificities of this business.