



HM TREASURY



UK Response to Commission Green Paper on the Enhancement of the EU Framework for Investment Funds

Overview

Creating a single market in financial services is at the core of economic reform in the EU. And because of its key role in the investment chain, achieving an efficient single market in asset management is central to that agenda. Through the investment chain, savers and borrowers are brought together – bringing finance to business and opportunities for savers to manage their finances over their lifetime. The efficiency of this chain, which links individual savers to firms seeking capital for investment, is critical to allocating capital to the most profitable investments, providing a mechanism for saving, raising productivity, and in turn, improving competitiveness in the global economy.

2. In spite of some recognised weaknesses, the UCITS framework has delivered many of the benefits of the single market to the retail fund management industry. The framework has delivered a volume of cross-border trade which, although still small in percentage terms, is nonetheless significant and appears to be growing. Furthermore, UCITS is now a recognised brand outside the EU, facilitating substantial export business for EU financial services companies. The UK authorities believe that the priority now must be to build on this success. The UK's five priorities for post-FSAP are relevant, in particular:

- **Better implementation** – the fundamental framework to allow cross-border trade in investment management services is already in place. The priority now must be to implement it properly.
- **Alternatives to EU regulation** – supporting the ongoing work within the industry on standardisation of fund processing.
- **Better regulation** – carrying out robust, defensible cost/benefit analysis on any legislative proposals.
- **Making Lamfalussy work well** – even closer regulatory co-operation through CESR to deliver consensus on notification and eligible assets.

- **Recognising the global nature of financial markets – UCITS** providers sell not only in the EU, but also in other markets (for example Asia and Switzerland). The impacts of any changes to UCITS on the ability of firms to do business in these markets must be taken into account.

3. Some key areas where the existing framework could be made to work better are already being dealt with through CESR. We support this work and believe the Commission should do everything it can to ensure that the CESR work delivers a worthwhile outcome. Success here will lessen any perceived need for more resource-intensive options such as Directive overhaul, so CESR should be given every chance to succeed.

4. The UK strongly supports the Commission's view that the focus should be on exhausting the possibilities offered by the existing framework. It is only without prejudice to this overriding goal that consideration can be given to setting the direction of policy in the longer term, and the discussion of longer-term policy goals contained within this response must be read in that context.

Priorities

5. The UK believes that one of the key outputs of this consultation process should be to establish consensus on priority actions to improve the functioning of the UCITS framework. We see the immediate priorities as the following:

- **Notification** – reducing the costs to firms (and therefore to investors) of selling funds outside their home Member State;
- **Private placement** – work to design and implement a harmonised regime for private placement, allowing products aimed at institutional and sophisticated investors to benefit from similar cross-border freedoms to those already enjoyed by UCITS;
- **Management company passport** – allowing companies operating cross border greater freedom to rationalise their operations and so cut costs for investors; and
- **Simplified prospectus** – making further progress towards genuinely simplified and consistently implemented disclosure that adds meaningful clarity for investors.

6. These are the issues we believe should be addressed first. On these issues, particularly on notification and on the simplified prospectus, we believe that widespread consensus has existed for some time on the required outcomes. We believe that the role that now falls to the Commission is to set a firm timetable and to drive delivery of those priority actions where the agenda has already largely been set and to lead work on cost/benefit analysis in the areas where further work is required.

Making Existing Legislation Deliver (Q1 and Q2)

7. The UK authorities agree with the priority action areas for delivering greater legal certainty over the implementation of the directive. We do not see any significant additional concerns in this area. Turning to the specific areas raised:

- **Grandfathered funds** – we welcome the CESR guidelines and are reasonably confident that these should deliver the required certainty. We do not see any significant problems for the UCITS framework arising from this process.
- **Notification** – the UK has consistently emphasised the vital importance of a simple and broadly consistent notification procedure to the continued successful development of the UCITS framework. There are clearly significant problems in this area at present. We applaud CESR's efforts towards rectifying these problems. However, should it become clear that this avenue has been exhausted, we would encourage the Commission to consider further options for reform. This should include further investigation of the experts group report recommendation of removing the requirement for host Member State notification (perhaps with provisions for co-operation between supervisors to ensure the necessary information sharing). As more investors carry out fund transactions outside their home Member State, a regime of pure notification such as this would seem to have even greater attractions. The UK authorities see considerable merit in this option, although would of course emphasise that any options for legislative change should only be pursued where the benefits clearly outweigh the costs and where appropriate levels of consumer protection can be maintained.
- **Derivatives**– the Commission's recommendation on derivatives provided useful clarification and appears for the most part to have been successfully implemented.
- **Simplified prospectus** – a consistently implemented simplified prospectus has the potential to assist significantly the development of a single market in UCITS, particularly by making it easier for investors to compare funds from different Member States. This goal has not yet been achieved. We would encourage the Commission to give further consideration to how this framework could be improved. In particular, we would urge the Commission to start from a basis of considering what it is realistic for a typical consumer to take in from disclosure material, rather than what it would be desirable for a consumer to know, making use of targeted consumer testing to inform the process.

- **Eligible assets** – we support CESR’s work to clarify legislation in this area. Given the highly technical nature of this work, we believe it is especially important that every effort be made to resolve these issues within CESR, where such a large pool of technical expertise resides.

8. In general, the UK supports the efforts of CESR to deliver consistent implementation of the directives across the EU. It is vital that this channel should be exhausted before legislative action is considered, both to avoid unnecessary legislation and, should it be decided that legislation is required, to give legislators a precise representation of the problem in hand. However, CESR may well come up against problems (for example questions of national primary legislation) which it cannot resolve. The Commission should therefore remain closely involved in this work and be prepared to take action should it become clear that further progress within CESR is impossible.

The Management Company Passport (Q3 and Q4)

9. The UK believes that a fully operational management company passport could confer significant benefits on the EU industry. By allowing greater centralisation of management operations, the passport could deliver greater efficiency by allowing centres of excellence in management to develop within the EU. Allowing cross-border operators to centralise their management operations across borders should make it easier for them to monitor and ensure compliance, thus reinforcing consumer protection. We do not believe that split supervision would pose any problems in practice (particularly given the ongoing requirement to have a depositary in the same Member State as the fund). It would of course be important to reach agreement on a framework for appropriate division of responsibilities between regulators but this seems an entirely achievable objective.

Distribution (Q5, Q6 and Q7)

10. Well functioning distribution channels are essential to the proper functioning of the UCITS framework for two reasons:

- ensuring consumers get the right product; and
- encouraging competition amongst fund providers.

11. In encouraging competition, it seems likely that open architecture distribution frameworks will be preferable. Large and efficiently run funds will find it easier to gain further market share if they have good access to distribution networks. This in turn will promote consolidation. For the majority of EU firms, gaining access to new distribution channels is very costly and in some cases impossible. The UK would welcome further investigation by the Commission of the functioning of the market for financial services distribution in the EU. Given the highly diverse nature of EU distribution networks, this would seem likely to be an area where

alternatives to legislation would be more likely to deliver net benefits. One option could be to establish, in co-operation with the industry, a non-statutory definition of “open architecture” to allow distributors to self certify and make it easier for consumers to differentiate.

Longer-Term Work

12. As stated above, the priority must be to continue to work towards successful and consistent implementation of the existing UCITS framework. However, as flagged in the green paper, there are also several areas where targeted analysis could help in determining the UCITS policy strategy over the medium term.

Mergers and Pooling (Q8, Q9 and Q10)

13. The UK sees considerable merit in examining how to make cross-border fund mergers more viable, and to examine whether pooling of funds would contribute to a more efficient market. If so, it is important that permitted pooling types are sufficiently transparent so as not to interfere with the taxation of funds. As a first step, we would welcome a Commission assessment of the present barriers to mergers and pooling followed, if appropriate, by proposals for removing them.

14. In some circumstances, pooling is a second-best alternative to merging where merging is prevented by institutional or regulatory barriers. However, there are also instances where pooling is preferred to a full merger for internal management reasons. For example a company operating cross border and having established a significant presence in another Member State might set up a separate fund in that Member State with an investment style particularly suited to demand in that market but then wish to pool that funds assets with a hub fund. In this instance a full merger would not be appropriate. The Commission should therefore consider how best to facilitate both pooling (including master/feeder structures) and mergers.

The Depositary (Q11)

15. A passport for depositary services might assist the functioning of the UCITS framework by:

- making cross-border pooling easier; and
- increasing competition and efficiency in the market.

16. However, there are clearly non-trivial issues to be resolved, particularly in the varying roles assigned to depositaries in the field of oversight of the activities of the management company. In some Member States (including the UK), the depositary is assigned a crucial role in ensuring that the management company acts in the best interests of investors and in line with the rules of the fund, whereas as in other jurisdictions this responsibility could be shouldered to a greater extent by a board of directors of the fund. Given these differing

structures, considerable discussion between regulators, governments and industry would be required to deliver the necessary level of harmonisation without prejudicing consumer protection. On balance, therefore, we would recommend that this workstream receive only a low priority.

Broad Approach to UCITS Regulation Over the Longer Term (Q13 and Q19)

17. The Commission asks whether reliance on formal investment limits represents a sustainable approach to delivering high levels of investor protection. Retail investment markets evolve, and it is unlikely that any specific regulatory approach will remain optimal over the very long term. However, at present the UCITS regulatory framework, in spite of its flaws, is working well and the UK authorities see no benefit in the consideration of fundamental overhaul. Investigation in this area should receive only a low priority.

18. We would view adaptation of the UCITS legislation to the Lamfalussy approach in similar terms. While the UK is strongly supportive of Lamfalussy as an approach to Community financial services regulation, adapting the UCITS legislation to it would, as the Commission points out, be far from a cosmetic exercise. The cost of this re-engineering would be considerable, and it is far from clear that the incremental benefits would make the effort worthwhile at this stage. So we believe that while adapting UCITS to the Lamfalussy approach is desirable in theory, it should not be considered until such time (which we believe will be long into the future) as agreement can be reached across Member States, regulators and industry that fundamental reform of UCITS is required.

Investor Protection (Q14)

19. Conflicts of interest are unfortunately inevitable in financial services provision. The aim of regulation should, generally speaking, not be to eliminate but to manage them. We do not see any strong evidence that mismanagement of conflicts of interest is a fundamental problem in the UCITS framework but agree that this is a question which the Commission should keep under investigation.

Competition from Substitute Products (Q15)

20. The fundamental aim of the UCITS framework is to facilitate a single market in investment funds. This objective will only be prejudiced by competition from substitute products if that competition is so great as to dominate UCITS and thus severely limit the proportion of asset management business which can be done cross border. As the Commission points out, UCITS account for over 70 per cent of assets under management by the fund industry. This statistic gives no indication that substitute products pose a serious threat to UCITS. We do however recognise the risk that in the future regulatory disparities (in particular differing standards of disclosure) may lead to a shift towards other products and so would encourage the Commission to keep this situation under observation.

Private Placement (Q16, Q17 and Q18)

21. In June 2005, €731 billion of assets were held in special or institutional non-UCITS funds in the EU (source: EFAMA, September 2005). While much smaller than the combined UCITS assets (over €5 trillion), this is nonetheless a highly significant segment of the asset management industry. These funds are generally not sold via public offer but by private placement. The regimes governing private placement sales vary widely across the EU. This makes true cross-border operation difficult or impossible in this sector of the industry. Conversely, institutional and qualified investor asset management services seem to have several characteristics which make cross-border operation both feasible and desirable:

- **High degree of specialisation** – institutional funds often respond to a very specific set of investor needs (for example to match a particular set of liabilities). This implies that greater specialisation within the EU would be desirable, with centres of expertise in particular strategies being allowed to develop.
- **Reduced requirement for detailed rules** – because experienced and institutional investors do not require the same degree of regulatory protection as retail consumers the need for detailed conduct of business rules is reduced. This ought to facilitate the development of a common European regulatory approach.
- **Large average transaction size** – because average transactions via private placement are so large, investors are more likely to find it worthwhile to engage in a wide (and therefore cross-border) search for a provider. This suggests that if the regulatory impediments can be removed, a more integrated market should develop quickly.

22. In some Member States, no private placement regime exists. In most of the remaining Member States, some combination of the following types of rules apply:

- **Limits on the number of investors to whom the fund can be offered** – designed to ensure that the fund is not mass marketed. The difficulty with this rule in practice is that it is not always possible accurately to assess the number of investors to whom the fund has been offered, or indeed to define what constitutes an offer.
- **Minimum investment limits** – these have the advantage of being easily measurable, but may make diversification more difficult for some investors whose entire portfolio size is close to the minimum limit.

However, if the offer is mainly to institutional investors this may not be a biting constraint.

- **Qualifying investor rules** – requirements that investors demonstrate (or self-certify) certain levels of investment expertise, that they seek advice, or that they have some minimum level of net assets. In the UK's experience, the first two are useful criteria. The difficulty with a net assets criteria is that it is very difficult for firms and regulators to measure.

23. We strongly support the Commission's proposal to establish a working group to examine these issues and believe that a harmonised private placement regime could deliver substantial benefits for the EU asset management industry. We believe that the mandate of this group should focus on the private placement issue, where the goal is achievable and the potential benefits seem clear. When appropriate the Commission should include in its examination a cost-benefit analysis of each policy option so that the optimum choice can be made.

24. We do not believe that a case has been made for harmonised regulation of hedge funds and private equity funds themselves: in markets characterised by rapid and significant innovation the deadweight costs of regulation are likely to be large, and the high levels of investor competence and due diligence reduce any potential investor benefit from product regulation. We would however strongly support work to investigate the development of a common regime for the distribution of such investments. We do believe that this can be implemented independently of regulation of the fund managers themselves, harmonisation of which should not be a priority.